NOMURA

BANKS
Banks

Initiation of Coverage

SECTOR VIEW

New:	NEUTRAL
Old:	NOT RATED

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Indian Banks

Rising risks, falling returns …

We initiate coverage of the Indian banks sector with a NEUTRAL view. We believe the key drivers of bank earnings – loan growth, interest rates (bond yields) and asset quality — have turned negative in 4QFY09 and are likely to deteriorate further in FY10E. We expect earnings growth of Indian banks under our coverage to drop 6% in FY10 after a robust CAGR of 21% over FY05-08. While banks are faced with these challenges, we find some comfort in state-owned banks' valuations, which are trading at below book values, and fast-growing private banks, which are trading at 1-2x FY10E P/BV. We do not see positive catalysts for these banks in the next three to six months, except for policy rate cuts. Rather, we believe incremental newsflow on banks relating to fiscal measures and specific loan exposures turning bad will be negative for bank stocks.

- We initiate coverage of Punjab National Bank (PNB) and Axis Bank with BUY ratings. For State Bank of India (SBI) and Housing Development Finance Corp (HDFC), we recommend a REDUCE. We are NEUTRAL on ICICI Bank, HDFC Bank, Bank of India and Union Bank of India.
- Our target RoEs for these stocks are significantly lower than the banks' current RoEs (except for HDFC Bank), mainly because we have assumed higher credit costs of 1-1.2% of assets against the current low peak cycle credit costs of 0.4-0.6%.
- We expect the sector's loan growth to slow substantially to 12.5% after a robust 28% growth rate seen in FY05-08, as we believe slowing foreign capital inflows will weaken domestic demand.
- We expect non-performing loans (NPL) to grow 3x in FY08-11E, with growth in some banks as high as 5-8x. The sharp spike in NPL is likely to be driven by a large proportion of unseasoned loans at 36% of the sector's total loans.
- We see bank margins contracting. Banks are likely to lose pricing power, as we expect credit demand to remain weak, due to slowing corporate investments and pressure on households. In addition, declining credit deposit ratios and loans repricing faster than deposits will exert pressure on margins.
- A reversal of the bond rally in 4Q09, contrary to market expectations, is likely to trigger losses on banks' available for sale (AFS) bonds, and erode gains on their held-to-maturity (HTM) portfolios, in our view.

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Nomura Financial Advisory and Securities (India) Private Limited
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Coverage summary

Exhibit 1. Key metrics for Indian banks

FY10E	SBI	HDFC	HDFC Bank	ICICI Bank	Bank of India	Union Bank	Axis Bank	PNB
Ticker	SBIN IN	HDFC IN	HDFCB IN	ICICIBC IN	BOI IN	UNBK IN	AXSB IN	PNB IN
Current price (INR)	895	1,256	799	263	181	117	281	304
Price target (INR)	830	1,015	840	295	175	130	400	420
Rating	REDUCE	REDUCE	NEUTRAL	NEUTRAL	NEUTRAL	NEUTRAL	BUY	BUY
Potential upside/downside (%)	(7)	(19)	5	12	(3)	12	42	38
Net profit (INRmn) FY10E	81,975	24,778	28,887	39,955	21,389	17,618	16,748	22,152
EPS, INR	130	87	64	36	41	35	47	70
BVPS, standalone (INR)	1,004	508	454	451	250	168	320	474
BVPS consolidated (INR)	1,134	383	454	344	250	168	320	474
EPS CAGR FY05-08 (%)	16.0	27.3	22.7	11.1	76.3	20.7	27.2	13.2
EPS growth FY10E (%)	(11.4)	(0.6)	13.2	2.1	(27.8)	(9.5)	2.1	(9.3)
EPS CAGR FY09E-11E (%)	0.2	8.4	15.6	10.7	(6.7)	1.3	7.4	2.8
P/E (x)	7.2	14.0	12.5	7.5	4.8	3.5	6.3	4.4
P/BV (x)	0.9	2.4	1.8	0.6	0.8	0.7	0.9	0.7
P/BV after adjusting for subs (x)	0.7	2.2	1.8	0.4	0.8	0.7	0.9	0.7
Target P/BV, x	0.6	1.7	1.8	0.6	0.7	0.8	1.3	0.9
Target RoE (x)	10.0	19.4	19.9	10.0	10.9	11.1	15.3	12.3
Target CoE (x)	13.5	13.3	13.3	13.6	13.6	13.3	13.3	13.3
Value of core business , INR	690	650	839	161	175	128	400	421
Value of subsidiaries, INR	138	366	-	135	-	-	-	-
RoE (%)	13.6	17.9	16.1	8	17.4	22.5	15.6	15.7
RoA (%)	0.8	2.3	1.2	1.0	0.9	1.0	1.0	0.9
Tier-I (%)	8.4	13.5	8.9	10.8	8.1	7.5	8.6	8.2

Source: Bloomberg, Nomura estimates; Note: Pricing as March 9, 2009

Exhibit 2. Price performance

Absolute Price Performance (%)	**1 mth**	**3mth**	**6 mth**	**1 yr**
Axis Bank	(33.4)	(39.2)	(46.2)	(56.6)
Bank of India	(27.9)	(27.8)	(7.8)	(14.0)
HDFC Bank	(13.1)	(13.5)	(25.2)	(31.8)
HDFC	(15.8)	(22.4)	(39.4)	(49.5)
ICICI Bank	(38.6)	(34.3)	(63.8)	(61.8)
PNB	(24.8)	(32.4)	(29.2)	(32.1)
SBI	(22.0)	(24.7)	(31.9)	(44.8)
Union Bank	(21.8)	(18.6)	(8.3)	(9.3)
Sensex	(14.9)	(15.5)	(43.0)	(44.2)
Bankex	(26.1)	(26.7)	(47.6)	(49.8)
Relative price performance (%)	**1mth**	**3mth**	**6mth**	**1yr**
Axis Bank	(18.5)	(23.7)	(3.2)	(12.4)
Bank of India	(13.1)	(12.4)	35.2	30.2
HDFC Bank	1.7	1.9	17.7	12.4
HDFC	(1.0)	(6.9)	3.6	(5.4)
ICICI Bank	(23.8)	(18.8)	(20.8)	(17.6)
PNB	(10.0)	(17.0)	13.7	12.0
SBI	(7.1)	(9.2)	11.0	(0.7)
Union Bank	(6.9)	(3.1)	34.6	34.9
Bankex	(11.2)	(11.3)	(4.7)	(5.6)

Source: Bloomberg, Nomura research

Investment summary

Bank earnings will slow down with growth declining 6% y-y in FY10E

After witnessing robust earnings growth of 40% in 3QFY09E and 21% in FY05-08, we expect FY10 to be a weak year for banks' profitability. For Indian banks under our coverage, we expect earnings growth to decline 6% y-y and loan growth to weaken to 12% in FY10E, due to a slowing economy. In our view, the sharp decline in earnings growth is likely to be driven by weaker loan growth, rising credit costs and lower margins. We expect the sector's NPL to rise sharply by 3x over FY08-11E.

We expect earnings to decline y-y or remain flat for all the Indian banks under our coverage, as we expect slower loan growth and credit costs to rise sharply to 1-1.2%, from 0.4-0.6% currently. The only exception is HDFC Bank, which we expect it to witness healthy positive earnings growth of 20% y-y, although this will be lower than the bank's historical earnings growth of 30% y-y. HDFC Bank has been ahead of the sector in loan loss provisioning. The bank's credit cost was at 1.9% of loans in 3QFY09, substantially higher than the sector's 0.5%, despite the bank's impressive asset quality. As such, we believe HDFC Bank is unlikely to see a sharp rise in credit costs.

Target RoEs substantially lower than last reported RoEs and lower than CoEs as we model high, downcycle credit costs

Our target P/BV multiples of these banks are based on our target return on equity (RoE) that are substantially lower than current RoE (except for HDFC Bank), mainly because we have modelled in high downcycle credit costs of 1-1.2% for these banks against the current 0.4-0.6%. Except for HDFC Bank, HDFC and Axis Bank, our target RoEs are lower than the cost of equity (CoE) as we believe these banks' marginal RoE will be under pressure from higher credit costs, lower trading profits and slower margins.

Our target P/BV multiples are higher than the historical trough multiples, but lower than the mean one-year forward multiples, as they reflect the impact of the economic slowdown on bank earnings.

Bank stocks, except for ICICI Bank, have outperformed the Sensex over the past six months, although their price performance has been very volatile since the announcement of the Indian government's budget in mid-February 2009. In our opinion, the six-month outperformance was driven by strong earnings relative to other sectors and inexpensive valuations. Bank stocks have historically traded at a discount to market multiples. We expect the share prices of Indian banks to remain volatile over the next few quarters, as slow earnings and newsflow on specific loan accounts turns negative.

In this volatile environment, we would recommend to BUY Axis Bank and PNB, and to REDUCE HDFC and SBI. We are NEUTRAL on HDFC Bank, ICICI Bank, Bank of India and Union Bank.

SBI

REDUCE SBI: Our price target is INR830

We initiate coverage of SBI with a REDUCE rating and a 12-month price target of INR830. Our price target for SBI is based on 0.6x FY10E P/BV for the banking business and INR138 for subsidiaries, including life insurance. We believe SBI is most vulnerable to an economic slowdown, as it has grown its loans aggressively, especially over the past four quarters, and has high incremental exposure to sensitive sectors. SBI's provisioning cover of 48%, the lowest among the Indian banks under our coverage, provides little cushion for future delinquencies. SBI has seen the sharpest deterioration in the proportion of current and savings accounts (CASA) to 34% and the lowest incremental credit deposit ratio of just 2% in 3QFY09, indicating pressure on its incremental profitability and ahead of the other banks. Our FY10 profit forecast for SBI is lower than consensus estimates, as we build in higher loan loss provisions. We expect SBI's net profit to decline 11% y-y in FY10E against consensus expectations of flat growth.

HDFC

REDUCE HDFC: We see 19% potential downside.

We initiate coverage of HDFC with a REDUCE rating. Our 12-month price target of INR1,015 suggests 19% potential downside from the current level. HDFC is among the best managed finance companies in India, with a sound management team, strong risk management practices, strong earnings growth and impressive asset quality. However, we believe, like the rest of the sector, HDFC's earnings growth and asset quality will be affected by the economic slowdown. With pressure on borrower incomes and high property prices, we expect growth in home loans to decelerate to 20% by the end of FY09 and drop further to 15% in FY10E, much lower than the 27% y-y growth seen in FY03-08. We also expect the bank's NPL to rise from 1.01% of loans as at the end December 2008 to 1.51% in FY10-11E. Given HDFC's conservative lending practices and sound risk management, we expect its NPL to rise more slowly than the rest of the financial sector. However, we do expect loan loss provisions to rise sharply off a very low base, putting pressure on profit growth. As asset quality has never been an issue, HDFC's credit costs have been very low at just 3-7bp in FY03-08. With NPL rising, we expect the bank's credit costs to rise to 25-30bp of loans in FY10E-11E. In addition, with slower asset growth, higher credit costs, benign margins and lower trading gains, we expect HDFC's earnings to remain flat in FY10E on a low earnings growth of 2% for FY09E. We expect earnings to rebound to 18% in FY11E.

HDFC Bank

NEUTRAL on HDFC Bank. Strong fundamentals are priced in. Our price target is INR840 at 1.8x FY10E P/BV

We initiate coverage of HDFC Bank with a NEUTRAL rating and a 12-month price target of INR840. We expect HDFC Bank's profit growth to moderate to 19% over FY09-11E, from 30% in FY05-08, but it is still the strongest earnings growth compared with the other Indian banks under our coverage. Our price target is based on 1.8x FY10E P/BV, which is lower than its mean multiple of 3.2x in the past two years and its trough multiple of 2.2x. The bank is trading at 1.7x FY10E P/BV, making it the most expensive bank stock in India. Historically, the bank has traded at a significant premium to its peers, due to its high and consistently strong earnings growth of 30%, sound management team, strong loan loss cover and a strong deposit franchise. Our target multiple for HDFC Bank implies that this premium will be maintained. However, at the current price, we believe HDFC Bank's sound earnings outlook is priced in and we see limited potential upside from here. Hence, we have a NEUTRAL rating on the stock.

ICICI Bank

NEUTRAL on ICICI Bank with a price target of INR295, based 0.6x FY10E P/BV for the banking business and INR135 for subsidiaries

We initiate coverage of ICICI Bank with a NEUTRAL rating and a 12-month price target of INR295. We have valued the core business at 0.6x FY10E P/BV, using sustainable RoE of 10% and valuing its subsidiaries at INR135. A severe slowdown in the life insurance business has caused valuation multiples and consensus growth forecasts to contract sharply. ICICI Bank's stock price has corrected sharply, making it the least expensive banking stock under our coverage. However, we do not see upside to the stock, as we do not expect an earnings revival in the next few quarters and we expect incremental newsflow on specific loan accounts to continue to dampen investor sentiment. Lingering concerns over its international business, negative newsflow on specific loan accounts and low RoE are the key negative drivers for the stock, in our view.

Bank of India

NEUTRAL on Bank of India with a price target of INR175 based on 0.7x FY10E P/BV

We initiate coverage of Bank of India with a NEUTRAL rating and a 12-month price target of INR175. Bank of India has been among the fastest-growing state-owned banks in India, with net profit growth of 80% and loan growth of 26% in FY05-08. We expect earnings to decline 27% in FY10, driven by higher credit costs, lower trading gains, lower recoveries and pressure on margins. Our fair RoE of 11% assumes a provisioning cost of 1% against the current 0.5%. Our fair RoE is substantially lower than the current RoE of 18%, due mainly to lower credit costs and lower leverage.

Union Bank of India

NEUTRAL on Union Bank: Our price target of INR130 is based on 0.7x FY10E P/BV

Union Bank of India has been delivering strong operating performance over the past two years, driven by a substantial improvement in deposit mix and focus on brand building. The bank's provisioning cover is among the highest at 93%. While fundamentals are strong, we expect the bank's marginal RoE to come under severe pressure, due to declining margins, slowing growth and rising NPL. We expect its tier-I capital adequacy ratio (CAR) to fall to 7% by March 2011, but the bank does not have much leeway to raise fresh equity, since the Indian government has a 55% stake (which cannot fall below 51%). Our price target of INR130 at 0.7x FY10E P/BV is based on a target RoE of 11%, substantially lower than the bank's last reported RoE of 27%, due largely to high credit costs and lower leverage going ahead. The stock trades at 0.7x FY10E P/BV. We see limited potential upside to current valuations as we expect profitability to deteriorate.

Axis Bank

BUY Axis Bank at 0.9x P/BV FY10E. Our price target of INR400 is based on 1.1x FY10E P/BV, suggesting 42% potential upside

We initiate coverage of Axis Bank with a BUY rating and a 12-month price target of INR400, representing 42% potential upside from the current level. Our price target is based on our target FY10E P/BV multiple of 1.3x. Axis Bank has been the fastest-growing bank in India, with loans growing at 56% y-y and profits growing at 27% y-y in FY05-08. We expect flat (2%) earnings growth in FY10E and 13% in FY11E, substantially slower than the 9MFY09 growth rate of 73%, due to a moderation in loan growth to 25% over the next two years, rising credit costs and slower fees. While we expect a slowdown in earnings and a rise in NPL, we believe these negatives are priced in after the sharp price correction. Axis Bank trades at below book (0.9x FY10E P/BV), at the lowest level in the past five years, which we believe is unjustified given its growing brand franchise and strong management team.

With focused geographical expansion, Axis Bank's savings deposits per branch, which are a key indicator of brand strength, are higher than that of HDFC Bank and ICICI Bank. Our target multiple of 1.3x assumes a discount of 39% to HDFC Bank's target multiple, which is the average discount that it has traded at over the past two years. While we believe net profit growth will drop to 7% over FY09-11E, we believe its growth in core operating profit will remain strong at 23% in FY09-11E.

PNB

BUY PNB. Our price target of INR420 is based on 0.9x FY10E P/BV and suggests 38% potential upside

We initiate coverage of PNB with a BUY rating and a 12-month price target of INR420, representing 38% potential upside to the current level. Our price target is based on a target RoE of 12.3% and CoE of 13.3%. We expect the bank's earnings to decline 9% in FY10E, due to higher credit costs, declining margins and lower trading gains, and then recover 16% in FY11E. PNB has the highest proportion of low cost savings deposits at 31%. Provisioning cover is healthy at 83%, among the strongest in the sector. It has a relatively small 10% of total investments under the mark-to-market category. We believe these are key strengths under the current environment. PNB trades at 0.7x one-year forward P/BV, which is close to its historical trough of 0.75x. We believe there is potential upside to PNB's current price, given its healthy provisioning cover of 83%, which provides a cushion to absorb future shocks, technical NPL of INR5bn (out of INR33bn total NPL that is likely to be upgraded in the next few quarters, in our view) and a higher-than-sector CASA of 40%. PNB has underperformed the SENSEX sharply by 17% over the past three months despite strong results.

Risks and sensitivities to earnings

Key upside risks to our earnings and price targets for banks

- Faster loan growth. A higher-than-expected loan growth rate would improve the credit deposit (CD) ratio and would drive banks' earnings higher According to our sensitivity analysis, every 1pp improvement in the CD ratio would raise Indian banks' EPS by 1.3-1.5% on average.
- Cut in administered savings rate. The savings deposits rate for banks is fixed at 3.5% by the Reserve Bank of India (RBI). A cut in the administered savings rate would provide potential upside to our estimated earnings for banks and would benefit banks indirectly by giving them more scope to cut rates on term deposits.
- Higher foreign inflows. A substantial proportion of the high credit growth in the past three years was driven by high foreign inflows. A faster-than-expected growth rate in foreign inflows would drive both deposit and credit growth higher, posing upside risks to our earnings estimates.
- Lower delinquencies. We have assumed new NPL formation of 2-3% of loans for these banks. Lower-than-expected slippages resulting in lower provisions would pose upside risks to our earnings estimates and price targets for these banks. According to our sensitivity analysis, every 10bp decline in provisions / loans would raise earnings for banks by 5-6% in FY10E.

Key downside risks

Similarly, a slower-than-expected growth rate in loans, higher delinquencies and sticky deposit rates would act as key downside risks to our earnings estimates and price targets for banks.

The earnings of Indian banks will remain sensitive to bond yields and credit costs, given the rising NPL risk. Below, we show our sensitivity analysis of our FY10 earnings estimates to changes in major variables.

- For every 10bp rise in provisions to loans, banks' net profit would fall 5-8%
- For every 50bp cut in lending and deposit rates, earnings would decline 4-7%.
- For every 100bp rise in bond yields, banks' earnings would fall 4-13%, driven by higher mark-to-market (MTM losses.

Exhibit 3. Earnings sensitivities

Earnings sensitivity, FY10E	MTM losses from 100bp rise in 10 yr bond yield (%)	5% decline in loan growth (%)	10bp rise in credit costs (%)	50bp change in PLR and deposit rates (%)
Axis Bank	-7.50	-3.90	-6.40	-3.50
ICICI Bank	-7.50	-3.50	-5.70	-4.40
HDFC Bank	-7.00	-2.80	-4.60	-0.70
Bank of India	-6.40	-4.60	-7.50	-5.00
PNB	-3.50	-4.00	-6.50	-5.60
SBI	-13.40	-4.50	-7.30	-7.10
Union Bank	-9.00	-4.00	-6.60	-4.00

Source: Nomura estimates

Peak and trough valuations

We have looked at the peak and trough of one-year forward P/BV multiples. For all the Indian banks under our coverage, except for ICICI Bank, we have used data from April 1997 or from their dates of public listing. For ICICI Bank, we have used data from 2001, the year when ICICI merged with ICICI Bank.

Our target multiples for banks are higher than the trough multiples, but lower than the mean multiples, due largely to pressure on marginal RoE resulting from higher credit costs and slower loan growth.

Exhibit 4. Peak and trough P/BV multiples

P/BV (x)	Peak	When	Trough	When	Mean	Current	Target	Data period
Axis	4.6	Jan 08	0.54	Sep 01	1.56	0.92	1.3	From Apr 97 to date
HDFC Bank	7.0	Mar 00	1.70	Mar 99	3.24	1.8	1.8	From Apr 97 to date
HDFC adjusted for subsidiaries	5.7	Jan 08	1.10	Feb 99	3.3	2.2	1.7	From Apr 97 to date
HDFC unadjusted	7.0	Jan 08	1.10	Feb 99	3.5	2.4	1.7	From Apr 97 to date
ICICI Bank adjusted for subsidiaries	2.5	Dec 08	0.60	Dec 01	1.55	0.4	0.7	From Sep 01 to date
ICICI Bank unadjusted	3.3	Dec 08	0.60	Dec 01	1.63	0.6	0.7	From Sep 01 to date
Bank of India	2.4	Jan 08	0.40	May 02	1.05	0.8	0.7	From Apr 97 to date
Punjab National Bank	1.8	Jan 08	0.30	May 02	1.1	0.7	0.9	From Apr 02 to date
State Bank of India adjusted for Subsidiaries	1.9	Dec 07	0.34	Sep 01	0.91	0.7	0.6	From Apr 97 to date
State Bank of India	2.0	Dec 07	0.34	Sep 01	0.91	0.8	0.6	From Apr 97 to date
Union Bank	1.8	Jan 08	0.41	May 02	0.97	0.7	0.8	From May 02 to date

Source: Bloomberg, Nomura research

Loan growth for the sector at a modest 12.5%

Loan growth has slowed down substantially in 4Q FY09

According to RBI's latest data (up to mid-January 2009), the incremental credit deposit ratio for the banking system is just 1%, the lowest since 2001. While deposit accretion is strong, due to a lack of investment alternatives, loan growth has slowed substantially on the back of slowing economic activity.

Exhibit 5. Incremental credit and deposit growth over November-January for FY01-FY09

	FY09	FY08	FY07	FY06	FY05	FY04	FY03	FY02	FY01
Incremental credit (INRbn)	14	1,431	1,250	700	487	344	150	206	216
Deposits (INRbn)	1,131	1,702	1,194	421	737	473	302	212	477
Loan deposit ratio (%)	1	84	105	166	66	73	50	97	45

Source: RBI

Lowest quantum of incremental credit since FY01

Incremental credit from November 2007 to January 2008 was just INR14bn, indicating the steep slowdown in both corporate and retail lending. Slowing industrial production, lower capacity utilisation, a drop in business confidence and delays in implementation of new projects are the key drivers of slower corporate loans, in our view. The slowdown in retail loans is even steeper, due to high interest rates and, more importantly, high property prices. Credit growth from April 2008 to January 2009 already slowed to 19% from 22% in FY08. Yet the y-y growth rate in the current fiscal looks strong, due to good growth in the first three quarters and the government's fertiliser subsidies.

The five-year boom has now ended

With a low incremental credit deposit ratio, the five-year boom cycle in credit has ended. Bank loans witnessed a CAGR of 23% over FY03-08, driven by CAGRs of 32% in retail loans, 33% in farm loans and 23% in other loans (mainly corporate loans), during the same period. Growth of Indian bank loans was the fastest in Asia during the period, higher than the India's nominal GDP growth of 15% from FY03-08. High capital flows supported the credit boom, which led to lower interest rates and strong domestic demand. Capital inflows rose from close to 2% of GDP in FY02 to over 6% in FY08.With lower inflows, which led to a slowdown in domestic demand and activity, we expect credit growth to slow down sharply.

Expect credit growth to drop to 12.5% in FY10

We expect credit growth to drop to 12.5% in FY10. We expect retail loan growth to slow to 10%, farm loan growth to slow to 10% (the slower growth is due to the inclusion of a US$10bn fertiliser subsidy introduced by the Indian government) and growth in other non-retail loans to slow to 15%. The growth rate of 15% in non-retail loans will be driven partly by the substitution of foreign borrowings by domestic borrowings. Excluding the substitution effect, we estimate the growth rate in other loans will be lower at 10%.

High property prices and high interest rates have already affected demand for retail loans. We expect the slowdown to continue in FY10E until property prices correct by 25-30% and interest rates start to fall, which we believe will happen gradually over the next three to four quarters. This means that the demand revival will likely happen only in FY11E.

Exhibit 6. Sector-wise bank credit growth

(INRbn)	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09E	FY10E
Loans	5,897	7,292	8,408	11,004	15,071	19,312	23,619	28,192	31,724
% y-y		24	15	31	37	28	22	19	12.5
Retail loans	920	1,400	1,890	2,670	3,757	4,879	5,710	6,395.20	7,034.72
% y-y		52	35	41	41	30	17	12	10
Agri loans	608	735	905	1,243	1,739	2,546	3,064	3,983.20	4,381.52
% y-y		21	23	37	40	46	20	30	10
Other loans	4,369	5,157	5,613	7,091	9,575	11,887	14,845	17,814	20,308
% y-y		18	9	26	35	24	25	20	14

Source: RBI, Nomura estimates

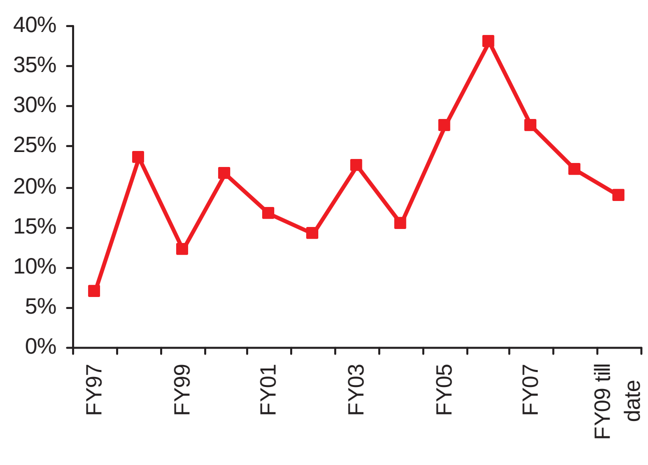
We expect deposit growth of 16%, stronger than credit growth of 12.5%.

We believe deposit growth will be strong, as banks are reluctant to cut rates aggressively given the volatile bond yields. Managements of some state-owned banks also believe that high rates on government small savings schemes are a deterrent to deposit rate cuts.

Lower loan deposit ratios will hurt earnings

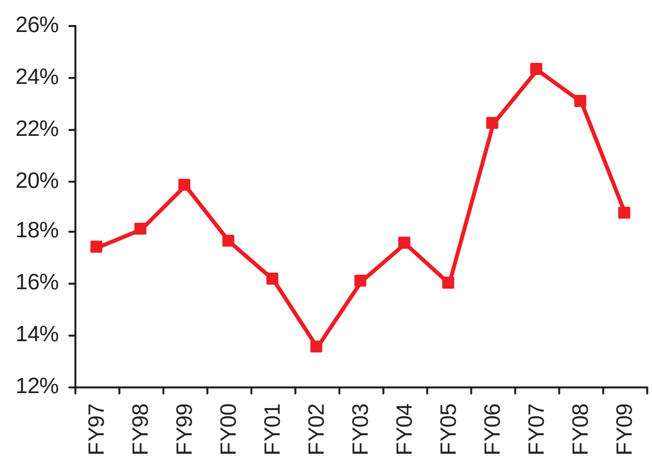
A sharp slowdown in loan growth and healthy growth in deposits will bring down the loan-deposit ratio to less than 70%, from 75% in FY08 and 71% as of end-January 2009. Declining credit deposit ratios will hurt the earnings of India banks, as the banks will have to park their excess funds in lower yielding government bonds. Already, Indian banks have 31% of their deposits parked in lower-yielding government bonds as against the required 26%.

Exhibit 7. Loan growth – strong over FY05-09



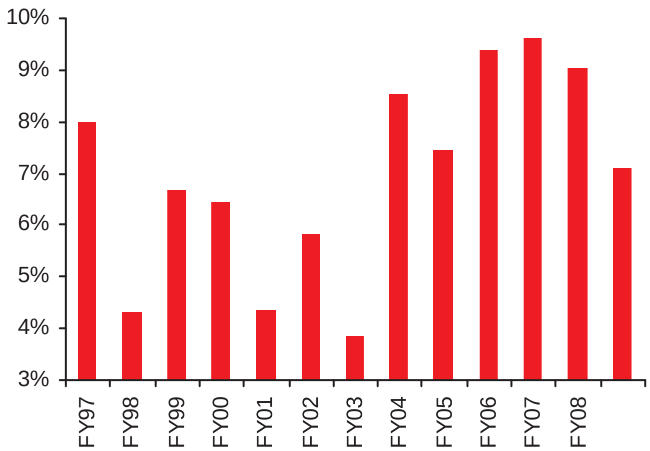
Source: RBI

Exhibit 8. Deposit growth for the system



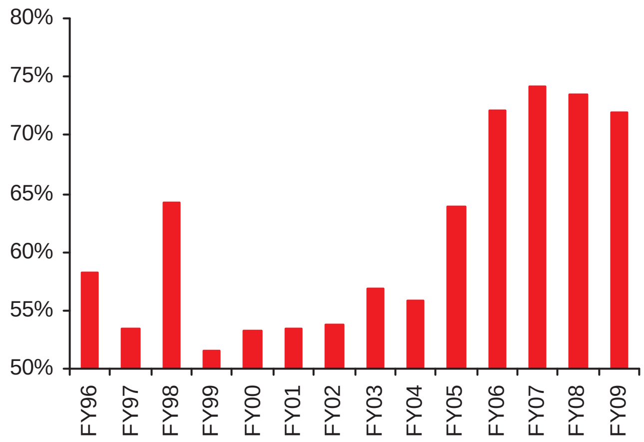
Source: RBI

Exhibit 9. Real GDP growth



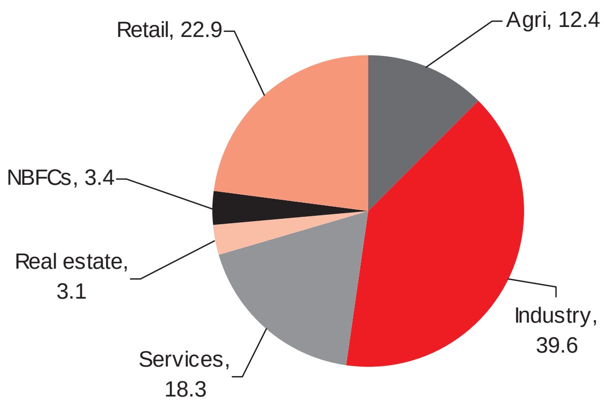
Source: Bloomberg

Exhibit 10. Rising CD ratio



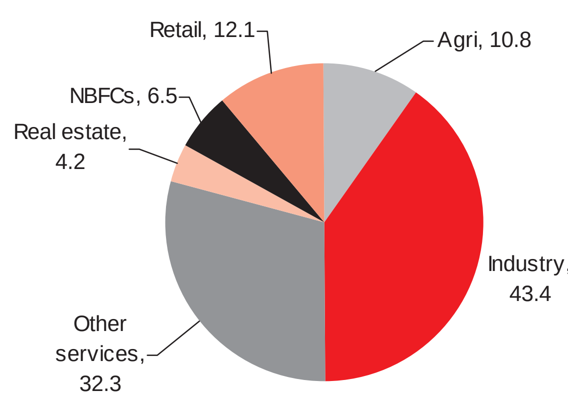
Source: RBI

Exhibit 11. Breakdown of sector non-food loans for FY08 (%)



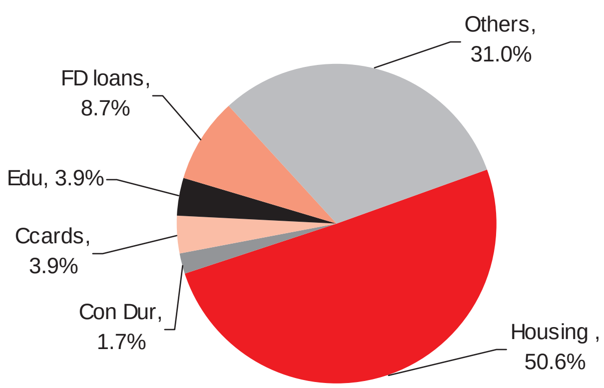
Source: RBI

Exhibit 12. Breakdown of incremental non-food loans, FY08 (%)



Source: RBI

Exhibit 13. Breakdown of system retail loans, FY08 (%)



Source: Bloomberg

Exhibit 14. Growth in non-food loans

CAGR 08-06	**(%)**
Agri	25.3
Industry	25.8
Services ex retail and NBFCs	40.4
Real estate loans	51
NBFCs	48
Retail	18.4
Total loans	24.7

Source: RBI

Deteriorating asset quality

With a sharp slowdown in economic activity and corporate profits under pressure, we expect to see a sharp rise in bad loans. The y-y growth rate in NPL has already been quite sharp for most banks in 3QFY09. Higher credit costs, driven by higher NPL, will put pressure on bank earnings.

Indian banks have a high proportion of unseasoned loans, leading to higher NPL risks

In our opinion, what is at risk is unseasoned loans, the proportion of which is high in the current credit cycle. At 54%, the proportion of loans lent over the past three years by Indian banks is at an all-time high.

Exhibit 15. High proportion of unseasoned loans

	Total bank loans (INRmn)	Loans outstanding for two years to total loans (%)	Loans outstanding for three years to total loans (%)
FY94	164,602		
FY95	199,635		
FY96	244,209		
FY97	270,790	26	39
FY98	300,644	19	34
FY99	352,054	23	31
FY00	410,267	27	34
FY01	471,442	25	36
FY02	535,744	23	34
FY03	679,736	31	40
FY04	820,171	35	43
FY05	1,059,308	36	49
FY06	1,466,387	44	54
FY07	1,876,672	44	56
FY08	2,304,094	36	54

Source: RBI

RBI relaxation in the restructuring of bad loans will delay the actual recognition of NPL by three to four quarters, in our view

RBI has extended the deadline for restructuring banking loans to June 2009. We believe the restructuring of potentially stressed assets will only delay the formation of NPL, not avoid it. As investors are already aware of the restructuring flexibility, we believe they are likely to treat a substantial proportion of the disclosed restructured assets as bad loans.

According to managements of Indian banks, most of the commercial real estate loans have already been restructured in 4Q FY09, and a lot of small and medium enterprise (SME) loans and other corporate loans are likely to be restructured by the end of June.

Estimating bad loans for the system

Exposure to sensitive/vulnerable sectors accounts for around 30% of total bank loans, as shown in the table below. Assuming that 30-35% of these vulnerable loans are up for restructuring, new bad loans in the system could be more than 2x the existing stock of NPL.

Exhibit 16. Potential stressed loans

(%)	Dec 2008	Percentage exposure in the past three years	Weighted exposure
Textiles	4.10%	56%	2%
Iron and steel	3.90%	54%	2%
Vehicles	1.40%	64%	1%
Gems and jewellery	1.10%	46%	1%
Others	6.30%	33%	2%
Total industry	16.80%		8%
Non industry			
Small scale	5.90%	54%	3%
Transport operators	1.50%	98%	1%
Trade	5.70%	63%	4%
Real estate loans	3.10%	68%	2%
Total non industry	16.20%		10%
Assuming 35% apply for restructuring			6%
Assuming 50% apply for restructuring			9%
Total gross loans of India banks as of Mar 08			25,079
Gross NPAs as of March 2008			564
Existing restructured assets			150
Estimated restructured loans over the next two years			1,601
New bad loans / Existing stock of gross NPAs (x)			2.24

Source: RBI, Nomura research

The asset quality of Indian banks improved substantially from FY02-08, driven by strong economic growth, better risk management practices and the implementation of the foreclosure law that increased the pace of bad loan recoveries. With a sharp slowdown in economic activity, we expect higher delinquencies and slower recoveries.

We expect NPL in FY11 to be 3x the FY08E level

We expect gross NPL to rise to 3.7% in FY10 and 4.7% in FY11, from 2.5% of loans in FY08.

Exhibit 17. Gross NPLs will rise sharply

Gross NPL (INRmn)	Axis Bank	HDFC Bank	ICICI Bank	Bank of India	PNB	SBI	Union Bank	Total
FY04	2,747	3,356	67,500	33,951	46,701	126,672	23,468	304,396
FY05	3,111	4,392	51,400	28,724	37,413	124,557	20,582	270,179
FY06	3,779	5,089	29,600	22,044	31,383	96,283	20,981	209,158
FY07	4,187	6,578	42,100	18,896	33,907	99,982	18,726	224,376
FY08	4,946	9,070	83,500	17,744	33,189	128,373	16,566	293,388
3QFY09	7,879	19,114	96,400	22,127	32,644	133,000	15,640	326,804
FY09	10,009	19,114	108,900	25,534	37,090	157,547	17,275	375,468
FY10	23,865	23,248	157,905	58,885	69,054	243,156	35,408	616,648
FY11	41,561	40,699	205,277	89,100	88,494	317,794	54,364	853,897
FY08/FY05,x	1.6	2.1	1.6	0.6	0.9	1.0	0.8	1.1
FY11/FY08,x	8.4	4.5	2.5	5.0	2.7	2.5	3.3	2.9
FY11/3QFY09, x	5.3	2.1	2.1	4.0	2.7	2.4	3.5	2.6

Source: Company data, Nomura estimates

Interest rates: bond yields are rising despite sharp cuts in policy rates

Aggressive easing by RBI

RBI has cut policy rates sharply for liquidity support. However, despite aggressive easing, bond yields have been volatile due to concerns over the government's borrowing programme. As such, we believe lending and deposit rates will fall only gradually.

RBI has cut the cash reserve ratio (CRR) by 400bp, from the peak of 9% in September 2008 to 5% now. It has cut the reverse repo rate from 6% to 3.5%. The central bank has also cut the statutory liquidity ratio (SLR), from 25%, to 24%.

Yet bond yields have remained volatile

The benchmark ten-year bond yield touched a high of 9.2% in July 2008, due to a high inflation rate driven by oil and non-oil products. Given the correction in oil prices and the global slowdown, inflationary pressures in India have eased. Furthermore, the RBI has cut its policy rates sharply since October 2008. Policy easing and low inflation has led to a 400bp rally in g-sec yields — the ten-year bond yield touched a low of 4.85% in December 2008. After a good rally in 3Q, and early-4Q, investors had been expecting bond yields to decline because of slower credit growth and declining global rates. Investors viewed this positively, as lower rates would give banks, especially government banks, an opportunity to book bond profits and cut lending rates to boost loan growth. However, contrary to market expectations, bond yields started to rise again in 4Q09. The bond market remains concerned over three issues: 1) the additional government borrowing programme of INR450 bn in FY09 to fund the stimulus packages and more importantly, 2) the significant net government borrowing of INR3,086bn for FY10, which is significantly higher than consensus estimates of INR2-2.5tn and 3) the government also expressed the need for enhancing plan expenditure (at least by another 0.5-1.0% of GDP) in the subsequent regular budget.

Bond yields will remain volatile in FY10E due to the significant government borrowing programme

We believe we could see a relief rally when the RBI cuts policy rates again. However, according to our discussions with the banks, bond yields will likely move up again in 2H FY10 with the new government's budget in place.

Tight liquidity situation

An analysis of the sources and uses of funds by banks indicates that, despite our forecast of weak credit growth of 12.5% and healthy deposit growth of 16% in FY10, the sources of funds by banks will just about equal the uses of funds, suggesting a tight liquidity situation. We derive some comfort from the banks' excess SLR holdings, which account for 7.8% of deposits, according to the latest data by RBI. According to our sensitivity analysis, just 1% excess credit growth will lead to uses of funds being higher than sources of funds by INR250bn.

Exhibit 18. Uses and sources of funds for India banks

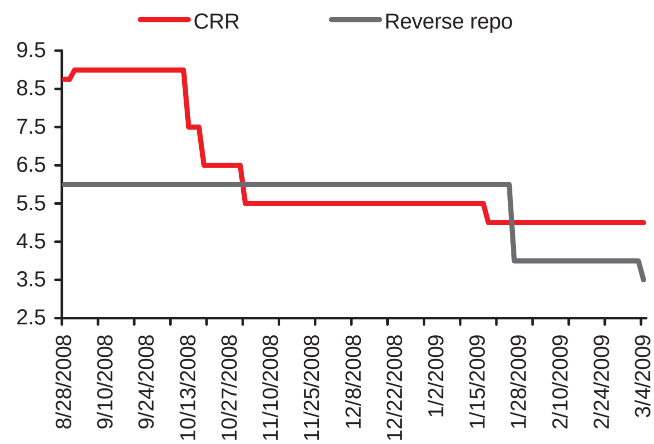
(INRtn)	FY10E
Gross borrowing program of the government budgeted for FY10E	3.6
Net borrowing program	3.1
Add extra borrowings required for recent tax cuts	0.225
Add additional spend at 0.5% of GDP as suggested by the budget	0.3
Total borrowing program	3.6
Less Market Stabilisation bonds (MSS) available	0.9
Net of MSS	2.7
Bank's share at 55%	1.5
Incremental credit assuming 12.5% y-y growth in FY10E	3.4
SLR at 24% of incremental deposits	1.4
Total uses of funds	**6.3**
Incremental deposit growth	6.0
Repo balances parked with the RBI	0.4
Total sources of funds	6.3

Source: RBI, Nomura estimates

Exhibit 19. Ten-year bond yield remains volatile

Source: Bloomberg

Exhibit 20. Aggressive policy rate cuts



Source: RBI

Volatile bond yields will be a negative for banks

- Banks will lose the unrealised gains on their HTM bond portfolios, which they could have used to offset MTM provisions on available for sale (AFS) portfolios.

  As bond yields are up q-q, investors are once again wary about rising MTM losses at state-owned banks. We believe state-owned banks have HTM gains that can be used to offset some losses on the AFS portfolio. However, we believe state banks may at best be in a position to realise only 10-20% of their MTM gains, which means that we could see some AFS losses in the next few quarters if bond yields do not ease.

- In the table below, we have estimated MTM gains and AFS losses of state banks under our coverage, assuming that the ten-year bond yield would touch 7%. We have assumed a yield of 8% on the existing HTM portfolios. Therefore, the excess return on the HTM portfolio will be calculated as: (8% minus 7%) * duration* value of the HTM portfolio. For the AFS portfolio, we have estimated the losses for a 1% increase in yields.

Exhibit 21. MTM losses and HTM gains of state banks

	AFS (INRbn)	HTM (INRbn)	Total (INRbn)	Duration of AFS (years)	% AFS	Unrealised gains (INRbn)	Unrealised gains as % of net worth	MTM losses (INRbn)	as % of net worth
Bank of India	98	368	466	2.0	21	15	7.5	2.0	1
PNB	66	567	633	2.0	10	23	10.4	1.3	1
SBI	828	1622	2,450	1.8	34	65	7.2	14.9	2
Union Bank	152	260	412	1.4	37	10	8.6	2.1	2

Source: Company data, Nomura estimates

- We believe banks will be reluctant to drop deposit rates if bond yields remain firm. This implies pressure on bank margins and on loan growth.

- Banks' excess holding of g-secs at 7.8% above the required SLR of 24% will rise even further, putting more pressure on spreads and profitability, as banks park more deposit in g-secs rather than higher yielding loans.

Deposit and lending rates: pressure on spreads unavoidable

Deposit rates are not falling fast enough

We believe bank managements are reluctant to cut retail deposit rates and align them to other benchmark rates. Currently, state banks have a competitive edge in deposit taking, as they are perceived to be safer than private banks. The state banks we spoke to are also unwilling to drop retail deposit rates significantly until rates on small savings schemes of the government ease, which in our view, is unlikely in an election year. As such, we expect retail deposit rates to fall only slowly. Bulk deposit rates have corrected sharply as liquidity has eased since December 2008. We expect bulk deposit rates to remain soft.

Lending rates have dropped faster than deposit rates

In the past one quarter, banks have cut lending rates more aggressively compared to cuts in deposit rates, due to slowing loan growth. Prime lending rates (PLRs) have been cut by 150-200bp, while deposit rates have been cut by only 75-100bp. For certain loans, such as small home loans, export finance and lending to non-banking finance companies (NBFCs) for commercial vehicle loans and infrastructure, the cut in lending rates is sharper to accommodate the stimulus package of the government. SBI has cut its home loans rate to 8% for the first year, which is 200-300bp lower than that offered by its competitors.

Exhibit 22. Rate cuts

(bp)	PLR cuts	Deposit rate cuts
SBI	200	25-150
Union	150	100
PNB	175	25-100
BOI	150	100
BOB	150	25-75

Source: Company data

Margin pressure likely

Government banks witnessed margin expansion in 3Q FY09, due to cuts in reserve requirements and pricing power as they turned cautious. However, we expect pressure on margins from hereon for the following reasons:

- In 4Q FY09, bank managements witnessed a sharp slowdown in loan demand. This means that banks will have to be price takers, in our view. In addition, faster formation of NPL will put pressure on loan margins.

- Loans repricing faster than deposits will also put pressure on bank margins. The average deposit tenors of government banks are higher than those of private banks. Therefore, state banks could witness higher pressure on margins.

- Declining credit deposit ratios will also put pressure on bank margins, as banks will park their excess deposits in lower yielding bonds.

- The table below shows the proportion of fixed rate loans and bulk deposits for banks. Banks with a higher proportion of bulk deposits and a higher proportion of fixed rate loans will see less margin pressure, which is largely the private banks, especially ICICI Bank and Axis Bank.

Exhibit 23. Fixed rate loans, bulk deposits and CASA

	Fixed rate loans as % of total loans	Bulk deposits as % of total deposits	CASA (%)
Axis Bank	45	30	38
HDFC Bank	15	55	40
ICICI Bank	47	60	27.6
Bank of India	15	35	32.0
PNB	27	30	37.41
SBI	15	30	34.4
Union Bank	16	35	33.3

Source: Company data

- The proportion of low cost deposits with banks is on the decline and we expect the trend to continue. For private banks, it was 'flight to state banks' that caused their CASA ratios to deteriorate; however, even state-owned banks saw their CASA ratios deteriorating, due to lack of alternate investment options and high real rates on retail term deposits.

- Benefits from cuts in reserve requirements will not be large enough to offset the above negatives.

Exhibit 24. CASA ratios – the decline continues

CASA (%)	3QFY09	2QFY09	3QFY08
Axis	38.0	40.3	45.3
BoI	32.0	32.0	37.0
HDFC Bank	40.0	44.0	50.9
ICICI	27.6	29.6	27.6
SBI	34.4	39.7	41.1
Union	30.4	33.1	33.1

Source: Company reports

Exhibit 25. Sensitivity of FY10 earnings to rate cuts

% to total earnings	50bp cut in PLR	50bp cut in deposits	50bp cut in CRR	50bp cut in SLR	Net impact
Axis Bank	-11	7.5	1.3	1.0	-1.2
HDFC Bank	-9	4.6	1	0.8	-2.6
ICICI Bank	-10	9.3	1.1	0.8	1.2
Bank of India	-14	9	1.2	0.9	-2.9
PNB	-14	8.4	1.3	1	-3.3
SBI	-15.5	8.4	1.3	1	-4.8
Union Bank	-16	12	1.6	1.2	-1.2

Source: Company data, Nomura estimates

Earnings growth to slow down substantially

We expect earnings growth for the Indian banks under our coverage to deteriorate to a low 3% in FY09-11E, from a strong 21% in FY05-08. We expect earnings to decline 6% in FY10, and then grow 16% off a low base in FY11. Slower loan growth, higher credit costs and pressure on margins will be the key negative earnings drivers, in our view. We believe the risks of revision to earnings are on the downside with lack of clarity on pension funding for state banks and lack of visibility of international operations. In our opinion, HDFC Bank is the only Indian bank that will show positive earnings growth of 16%, albeit slower than the 30% y-y- level seen in FY05-08. For all other banks, we expect their earnings growth to range between negative 30% and 2%.

Exhibit 26. Earnings growth for banks

EPS (INR)	**Axis Bank**	**HDFC Bank**	**ICICI Bank**	**Bank of India**	**PNB**	**SBI**	**Union Bank**	**HDFC**	**Total**
FY04	12	17	26	21	42	70	15	35	238
FY05	14	22	27	7	45	82	16	42	255
% y-y	20	29	4	-66	7	17	1	20	7.01
FY06	17	31	29	14	46	84	13	50	284
% y-y	20	37	5	106	2	2	-15	21	12
FY07	20	40	35	23	39	86	17	62	331
% y-y	14	29	21	60	-14	3	25	23	17
FY08	30	41	37	38	63	128	27	86	452
% y-y	50	4	8	66	61	48	64	38	37
FY09E	46	57	35	56	77	146	39	88	544
% y-y	54	37	-6	47	23	15	40	2	20
FY10E	**47**	**64**	**36**	**41**	**70**	**130**	**35**	**87**	**510**
% y-y	**2**	**13**	**2**	**-28**	**-9**	**-11**	**-9**	**-1**	**-6**
FY11E	53	76	43	49	82	147	40	103	592
% y-y	13	18	20	21	16	13	13	18	16
FY05-08, %	**27.2**	**22.7**	**11.1**	**76.3**	**12.1**	**16**	**20.7**	**27.3**	**21.0**
FY09-11E, %	**7.4**	**15.6**	**10.7**	**-6.7**	**2.8**	**0.2**	**1.3**	**8.4**	**4.3**

Source: Company data, Nomura estimates

Valuation methodologies

We have derived our price targets for these bank based on the Gordon Growth Model.

Our target RoEs reflect higher, downcycle credit costs

Our target RoE reflects downcycle credit costs of 0.9-1.2% of average assets against credit costs of 0.3-0.6% that banks have been reporting in the credit boom period over the past four years. This is one major reason why our target RoE for banks is significantly lower than the last reported RoE. We have also assumed very low trading gains.

Cost of equity

- We have derived our CoE using a risk free rate of 5% and equity risk premium of 6%.
- We have used sustainable growth rates of 5.5% for HDFC Bank and Axis Bank and 4.5% for other banks.
- We have valued the subsidiaries of ICIC Bank, HDFC and SBI based on relevant benchmarks.

Based on our fair values, we would recommend investors buy PNB and Axis Bank. We have REDUCE ratings on HDFC and SBI and NEUTRAL ratings on HDFC Bank, ICICI Bank, Bank of India and Union Bank. Except for policy rate cuts, we do not see any positive catalysts for bank earnings in the short term. On the contrary, we believe incremental newsflow will be negative on international operations of banks and on specific domestic exposures.

Exhibit 27. Valuation methodologies for banks

(%)	Axis	HDFC Bank	ICICI Bank	Bank of India	PNB	SBI	Union Bank	HDFC
Net int inc/assets	2.7	4.0	2.3	2.6	3.1	2.7	2.6	3.50
Non-int inc/assets	1.7	1.7	1.8	0.7	0.9	1.2	0.8	0.10
Non-oper profits /assets	0.1	0.1	-	0.1	0.1	0.1	0.1	0.15
Opex / assets	2.1	2.3	1.7	1.5	2.0	2.0	1.5	0.48
Oper profits/assets	2.4	3.5	2.4	1.9	2.1	2.0	2.0	3.28
Provisions/assets	1.1	1.3	1.3	1.0	1.0	1.2	1.0	0.5
(1-tax rate)	67	67.0	67.0	67.0	67.0	67.0	67.0	70.00
RoA	0.9	1.5	0.7	0.6	0.7	0.6	0.6	1.94
Assets/equity (x)	17	13.5	13.5	18.0	17.5	17.5	17.5	10.00
RoE	15.3	19.9	9.9	10.9	12.3	10.0	11.1	19.43
Risk free rate	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.50
Risk premium	6	6.0	6.0	6.0	6.0	6.0	6.0	6.00
Beta	1.3	1.3	1.4	1.4	1.3	1.3	1.3	1.30
CoE	13.3	13.3	13.6	13.6	13.3	13.5	13.0	13.30
g	5.5	5.5	4.5	4.5	4.5	4.5	4.5	4.50
Target P/BV	1.3	1.8	0.6	0.7	0.9	0.61	0.8	1.70
BVPS (INR)	320	454	344	250.4	474	1,134	164.4	383
Target price of standalone bank (INR)	402	839	206	175	421	690.4	128	650
Likely Impairment for foreign banking subsidiaries	-		45			-		
Fair value of subsidiaries	0	-	135	-	-	138		366
Price target	400	839	296	175	421	828	128	1,016
Rounded off to (INR)	400	840	295	175	420	830	130	1,015
Current market price (INR)	281	799	263	181	304	895.3	117	1,256
% upside from current price	42%	5%	12%	-3%	38%	-7%	12%	-19%
Recommendation	BUY	NEUTRAL	NEUTRAL	NEUTRAL	BUY	REDUCE	NEUTRAL	REDUCE

Source: Nomura estimates, Bloomberg, Note: Pricing as of 9 March 2009

Company section

State Bank of India — aggressive growth will now hurt

Stock rating: REDUCE
Sector view: NEUTRAL
Ticker: SBIN IN
Price as of 09 March (INR): 895
Price target (INR): 830
Potential upside/downside: –7%
YTD price perf (Abs): -31%
YTD price perf (Rel): -16%

We initiate coverage of State Bank of India (SBI) with a REDUCE rating and a 12-month price target of INR830 which implies potential downside of 7%. Our price target is based on 0.6x FY10E P/BV for the banking business and INR138 for subsidiaries, including life insurance. We believe SBI is the most vulnerable Indian bank to an economic slowdown owing to its aggressive loan growth, especially in the past four quarters and high incremental exposure to sensitive sectors.

Loan growth will slow to 12% in FY10: After a significant 27% loan growth over FY05-FY08, we expect SBI's loan growth to slow to 12% in FY10 on slowing economic activity.

Sharp decline in earnings in FY10: We expect earnings to drop 11% y-y in FY10 as credit costs rise, loan and fee growth moderates and the contribution from trading gains declines.

NPLs likely to rise 2.8x between FY08 and FY11E: We believe that with a large unseasoned book SBI's NPLs will rise sharply. We expect gross NPLs at 5% by FY11 as against 2.6% at end December 2008.

Exhibit 28. State Bank of India — summary of key financials and market data

Key financials (INRmn)	FY08A	FY09E	FY10E
Op profit	130,965	166,536	189,812
Net profit	67,291	92,490	81,975
EPS	128	146	130
DPS	21	18	18
BVPS	776	899	1,004
Yield	2.4	2.0	2.0
P/BV	1.2	1.0	0.9
P/E	7.0	6.1	6.9

Key ratios	FY08A	FY09E	FY10E
RoE (%)	16.7	17.5	13.6
RoA (%)	1.0	1.1	0.8
Tier I CAR (%)	9.3	8.5	8.6
EPS growth (%)	48.2	14.7	(11.4)

Market data	
Ticker	SBIN IN
Market cap (US$mn)	11,534
Shares outstanding (mn)	632
Free float (%)	40

Source: Bloomberg

Source: Company data, Nomura estimates, Bloomberg for price chart

Investment summary

Likely slowdown after rapid growth over the past three years: SBI's focus on improving loan and deposit market shares has paid off with robust 27% growth in loans over FY05-FY08. The y-y loan growth in 9M FY09 has also been very strong at 31% y-y. With slowing GDP growth, we now expect SBI's loan growth to slow to 12% y-y.

NIMs will decline: SBI's NIMs expanded 14bp y-y in 3Q FY09 as the bank benefitted from better pricing power in loans and CRR cuts. We do not expect the margin uptrend to continue. We expect NIM to decline 25bp in FY10 to 2.7% and then recover to 2.8% in FY11E, as lending rates come down in line with falling demand; we expect deposit rates to fall by a lower proportion.

SBI's CASA, which has traditionally been the bank's key strength, dropped sharply by 500bp to 34% at the end of December 2008. Depositors shifted their deposits from private to state banks in 3Q FY09 leading to strong growth in SBI's term deposits. While we expect CASA to improve to 38% in FY10, we expect it to be lower than the March 2008 level of 47% since we expect strong growth in term deposits with other investment options for depositors drying up.

We expect a sharp increase in SBI's NPL levels to 5% in FY10: We expect SBI's NPL levels to increase sharply to 4.7% in FY10 from the current 2.6% owing to a high proportion of unseasoned loans. Nearly 37% of SBI's outstanding loans were lent in the last two years at the peak of the credit cycle. In absolute terms, we expect NPLs to grow 58% y-y in FY10 and 35% y-y in FY11. We expect NPLs to grow 18% q-q in 4Q FY09.

We expect NPL provisions for SBI to rise sharply to 1.1% of loans in FY10 from a low 0.5% in FY08.

11% y-y drop in earnings in FY10: With lower margins, slower growth in loans and fees and high provisioning costs, we expect a 11% decline in SBI's earnings for FY10. We expect earnings to rebound in FY11 with 13% growth.

Our earnings forecast for FY10 is lower than consensus: Consensus estimates are still building flat earnings growth for FY10 as against our estimated 11% y-y decline in EPS. We believe the key difference is in loan loss provisions, where we have modelled 100bp against consensus numbers of 50-60bp.

We forecast SBI's Tier I CAR at 8.2% in FY11E. As such we believe the bank will not need fresh capital through FY11. However, we note that each time the bank needs fresh capital, the government will have to undertake a rights issue. The government holds a 59% stake in SBI and its stake cannot fall below 55%; this gives the bank little leeway to undertake a public issue.

Growth will also slow down for SBI's banking subsidiaries: SBI's banking subsidiaries reported strong growth for 9M FY09. The net profit for SBI's subsidiaries grew 102% y-y in 3Q FY09, but we do not have the detailed breakdown. We expect net profit for subsidiary banks to decline 10% in FY10.

Good performance of life insurance and asset management: SBI's life insurance subsidiary continues to register string growth amid a slowdown for the rest of the sector driven largely by the group's bancassurance model and its focus on group policies. Given significantly lower expenses than competition, SBI's life insurance subsidiary is already profitable and is the only private life insurance company under our coverage that makes a profit. New business premium for SBI Life in 11M FY09 rose sharply by 81% y-y against a decline in premium income for most other private players. As the focus is on the group business, margins are lower than competition, in our view.

SBI's assets under management (AUM) total INR278bn with the more profitable equity assets accounting for over 30%.

Price target of INR830

Our 12-month price target of INR830 for SBI comprises INR690 for the banking business and INR138 for subsidiaries.

Our price target for the core bank is derived using a target RoE of 10% and CoE of 13.5%. Our target RoE of 10% is significantly lower than the last reported RoE of 16.8% due largely to a sharp increase in credit costs to 1.1% of assets as against 0.4% in FY08.

Our fair value of INR138 for the subsidiaries is driven largely by life insurance. SBI Life has been growing faster than the sector and is in fact one of the few companies still registering positive y-y growth rates in premium collection among all the Indian players. We have valued life insurance as a sum of new business and existing business. We have assumed growth rates of 80% in new premium income in FY09 and 15% in FY10. Since SBI's focus is on the group business, we have assumed lower-than-sector margins of 15% for FY09, as against 19% for ICICI Prudential Life Insurance, and 14% for FY10. We have valued new business at 12x one-year forward NBAP (new business achieved profit).

We have valued SBI's asset management business at 2% of debt funds and 6% of equity funds.

Price target derivation methodology

Exhibit 29. Price target derivation for SBI consolidated

	FY08	Target
Net int inc/assets	2.6	2.7
Non-int inc/assets	1.2	1.2
Non-oper profits /assets	0.1	0.1
Opex / assets	2	2
Oper profits/assets	2	2
Provisions/assets	0.4	1.2
Other/assets		
(1-tax rate)	65.1	67
Minorities/assets	**-**	
RoA	1	0.6
Assets/equity (x)	16	17.5
RoE	16.7	10
Risk free rate		5.5
Risk premium		6
Beta		1.3
CoE		13.5
g		4.5
Target P/BV		0.6
BVPS of standalone Bank, FY10E		1,004
Add BVPS of subsidiaries, FY10E		226
Less investments in subsidiaries, F10E		96
Net BVPS		1,134
Fair value of the banking business		690
Value of subsidiaries		138
Consolidated fair value		828
Rounded off to		830

Source: Company data, Nomura estimates

Figure 30: State Bank of India — valuing subsidiaries

(INRmn)	Value of whole business	Value of SBI's stake	% holding
Fair value of life insurance	125,171	92,626.30	74
Fair value of Asset Mgmt	7,207.20	4,540.50	63
Fair value of other market investments	5,751.00	5,175.90	
Total value of subsidiaries	138,129	102,343	
Value after subsidiary discount		86,991	
Total fair value of subsidiaries per share		**138**	

Source: Nomura research

Exhibit 31: State Bank of India — value of new life insurance business

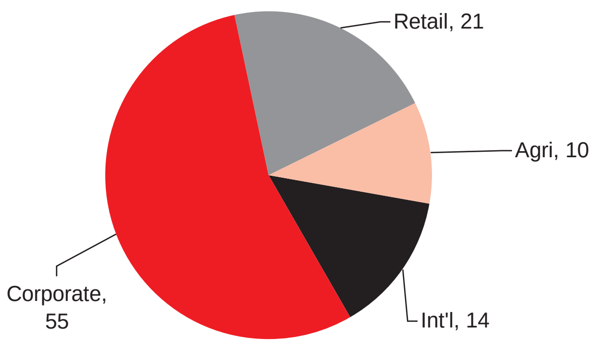
(INRmn)	FY06	FY07	FY08	FY09E	FY10E
Annualised premium equivalent	4,951	18,044	34,812	59,181	68,058
		264	93	70	15
NBAP margin (%)	18%	18%	15%	15%	14%
NBAP	891	3,248	5,222	8,581	9,528
Value at 12x				102,975	114,338

Source: Nomura estimates

Loan mix and asset quality

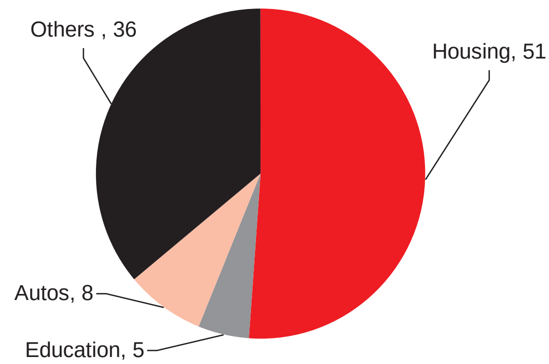
SBI's loan mix is dominated by corporate loans at 55% of total, followed by retail at 21%, international at 14% and farm loans at 10%. Housing is the biggest segment in retail at 51% of total retail loans. SBI's focus over the past two years has been to improve its market share of loans and deposits. It has seen rapid loan growth of 27% p.a. over FY05-FY08.

Exhibit 32. State Bank of India — loan breakdown



Source: Company data

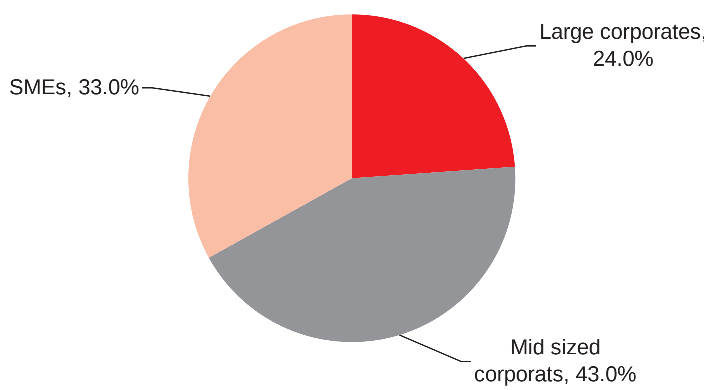
Exhibit 33. State Bank of India — retail loan breakdown



Source: Company data

The corporate portfolio is dominated by SME and mid-sized loans. SME loans account for 33% of total corporate loans and 17% of total loans. The chart below highlights the breakdown of SBI's corporate loans.

Exhibit 34. State Bank of India — corporate loan breakdown



Source: Company data

High risk from mid-sized, SME and international loans: Nearly 33% of SBI's outstanding loans were issued over March 2007 to December 2008, at the peak of the credit cycle. More importantly, the proportion of unseasoned loans is higher for SME, mid-sized and international loans posing greater risks in an economic downturn since these segments are more likely to be affected than others. Around 28% of SBI's incremental loan growth over March 2007-December 2008 came from mid-sized and SME loans and a high 20% came from international loans.

SBI has not provided details on loan or profitability breakdown for its international assets. According to management, a large part of these loans are to Indian companies to fund global acquisitions and trade. With a lot of foreign bonds of Indian companies trading at 30%-plus discount, we believe SBI will see write-downs on international loans, which have been the fastest growing lending segment for the bank over the past 1.5 years.

We expect SBI's NPL levels to increase sharply to 5% in FY10 from the current 2.5% owing to a high proportion of unseasoned loans. Its low provisioning cover of 48% provides little cushion to absorb future shocks. SBI's new NPL formation of 1.9-2.3% of loans over FY06-FY08 is in any case higher than sector averages. We expect new NPL formation to rise to 3.3% of loans in FY10 and 3.0% in FY11.

Exhibit 35. State Bank of India — movement in NPLs

(INRmn)	Gross NPLs	Net NPLs	Slippages (%)	Gross NPLs (%)	Net NPLs (%)	Provisioning cover (%)
FY02	154,859	68,103	3.60	11.90	5.60	56
FY03	135,061	61,830	3.90	9.40	4.50	54
FY04	126,672	54,417	4.20	7.70	3.50	48
FY05	124,557	53,489	2.70	5.90	2.60	64
FY06	96,283	49,064	2.10	3.60	1.90	47
FY07	99,982	52,577	1.90	2.90	1.60	54
FY08	128,373	74,243	2.30	3.00	1.80	50
FY09E	157,547	99,025	2.70	3.00	1.90	47
FY10E	243,156	149,035	3.30	4.20	2.60	50
FY11E	317,794	182,678	3.00	4.70	2.80	55
CAGR, FY08-FY11E	35.30%	35.00%				

Source: Company data, Nomura estimates

The much talked about 8% home loan scheme

Since 2 February 2009, SBI has begun offering home loans at 8% for a period of one year to all borrowers. After one year, the rates would be reset depending on whether the customer wants to opt for fixed or floating rates. At 8%, SBI's home loans are the cheapest in the Indian market at present. State banks other than SBI offer home loans at 8.75-9.75%. ICICI Bank and HDFC offer loans at close to 11%. At 8%, SBI is likely making negative incremental RoAs on home loans with its average cost of funds at 6% and one-year deposit rate of 8.5%. Our discussions with other banks indicate that most of the subscribers to this scheme are existing home loan borrowers of other banks, mainly ICICI Bank and HDFC, who want to transfer their home loan accounts to SBI to avail of the lower rates. The scheme is open until April 2009.

Key earnings drivers

- We expect net profit to grow 38% in FY09. The growth in net profit for 9M FY09 is already strong at 37% y-y. EPS growth will be slower at 14.7% owing to the dilution from SBI's rights issue in March 2008. SBI has witnessed strong earnings growth of 24% over the past two years driven by high loan growth, strong fee income, high treasury gains and lower-than-sector provisioning costs.

- We now expect earnings growth to decline by 11% in FY10, due mainly to high loan-loss provisions, slower loan and fees growth and low trading gains.

- We expect loan growth to moderate to 12% for FY10 from 27% over FY05-FY08 and 31% during 9M FY09.

- We expect NIMs to fall to 2.7% in FY10 from 3.15% at end December 2008 since we expect banks to lose the strong pricing power in loans that they enjoyed in 3Q FY09. Due to the liquidity crunch and the cautious approach of banks, lending rates increased sharply in 3Q FY09. For SBI, the yield on loans to large corporates rose sharply from 8.57% in 2Q FY09 to 10.2% in 3Q FY09 and yield on loans to mid-sized corporates rose to 11.7% from 9.7%. However economic activity has weakened substantially in 4Q FY09. Owing to weak demand, banks will now have to offer lower lending rates. Also deposit rates are not falling fast enough, which is putting pressure on NIMs.

- We expect CASA to recover to 38% from a low of 34% but we do not see it going back to the 40%-plus range: SBI's CASA, which has traditionally been the bank's key strength, fell sharply by 60bp from 40% to 34% in 3Q FY09. While savings deposits saw strong 27% growth, term deposits grew faster, causing CASA to deteriorate. Following unfounded speculation about ICICI Bank's liquidity position (source: 'ICICI Bank, subsidiaries well capitalised: RBI' DNA, September 30, 2008), many depositors, both retail and corporate, shifted their deposits from private banks to state banks in 3Q FY09 driving 45% y-y growth in the term deposits of SBI. While we expect private banks to regain some lost market share, we expect SBI's term deposit growth to outpace CASA growth since banks are not cutting deposit rates aggressively and there are few investment alternatives for depositors given the slowdown in capital markets. We also expect current deposits to decline with the slowdown in economic activity.

- We expect loan loss charges to rise sharply to 1.1% of loans from 0.5% in FY08.

- Operating expenses for SBI have seen modest growth over FY05-FY08 at 5% p.a. The slower growth was driven by low growth in employee costs at just 1% p.a. since the bank benefitted from lower provisions for employee benefits such as pensions and gratuity due to excess provisions made earlier and due to retiring employees. Growth in operating expenses picked up in FY09 with operating expenses growing 31% y-y in 3Q FY09, driven largely by provisions towards the new wage agreement and a provision of INR7.5bn towards the pension shortfall. We expect operating expenses to grow 27% in FY09 and then slow down to 3% in FY10 on a high base.

- We expect core fees to grow 12% in FY10 and 16% in FY11.

- SBI raised fresh capital of INR167bn in February 2008 though a rights issue by offering one share for every five held at INR1,590 per share, which was a discount of 35% to the last closing price. SBI's current Tier-I under BASEL II at 9.4% is adequate to support growth over the next two years, in our view. We model Tier-I to fall to 7.9% by March 2011. While we do not see the need to raise fresh capital, SBI's chairman has announced that the bank will likely initiate talks with the government after the general elections in India (scheduled for April-May 2009) for a fresh rights offering of US$5bn. The rationale is to build up adequate funds to capitalise on potential global M&A opportunities.

Valuation and price performance

Adjusted for subsidiaries, SBI trades at 0.7x P/BV on one-year forward numbers. We see further downside to SBI's multiples as we expect NPLs to rise sharply and earnings to decline by 11% y-y. Lack of clarity on the bank's international operations and the possibility of higher government-directed lending amid the ongoing economic slowdown are additional negatives. SBI traded at its historical lows in FY03-FY04 at around 0.5x P/BV one-year forward. The stock has outperformed the Sensex by 10% over the past six months and performed in line with the market over the past year.

Management team and strategy

Mr O P Bhatt, the current chairman of SBI, took charge in June 2006. His focus has been on revamping the IT infrastructure and improving market share of loans and deposits. SBI's market share of deposits improved 200bp y-y to 17.5% in December 2008. Mr Bhatt is among the few SBI chairmen with a five-year tenure. The tenure of the last five chairmen was about two years or less. Mr Bhatt is due to retire in March 2011. SBI's focus on market share is likely to continue, with the bank offering special home and auto loan schemes, where rates are lower than those of other banks.

Investment risks

- Faster-than-expected loan growth and lower delinquencies are key upside risks to our rating and earnings forecasts for SBI.

- A cut in the administered rate on savings deposits would also serve as a key upside risk to our earnings.

- Higher foreign inflows and faster-than-expected GDP growth would also drive SBI's earnings higher than our forecasts.

Financials

Exhibit 36. State Bank of India — profit and loss

Year-end 31 Mar (INRmn)	FY07	FY08	FY09E	FY10E	FY11E
Interest earned	372,421	489,503	654,071	749,188	871,392
Interest expended	221,840	319,291	429,197	502,784	585,673
Net interest income	150,581	170,212	224,874	246,403	285,719
Fees and comm	48,045	59,143	69,788	78,163	89,887
Profit on sale of inv	5,678	16,498	10,000	6,000	5,000
Loss on reval of investments	-6,407	-7,035	0	0	0
Profit on foreign exchange transactions	3,315	6,927	7,966	8,683	9,464
Others	17,011	11,306	12,737	13,660	14,656
Noninterest income	67,641	86,839	100,491	106,505	119,008
Employee	79,326	77,859	96,545	98,476	105,861
Other operating expenses	38,909	48,227	62,284	64,621	73,843
Operating expenses	118,235	126,086	158,829	163,097	179,705
Pre-provision profit (Operating profit)	91,248	130,965	166,536	189,812	225,022
Provisions & contingencies	54,586	63,784	74,046	107,837	132,088
Net profit	45,501	67,291	92,490	81,975	92,934
EPS	86.26	127.65	146.45	129.8	147.15
DPS	16	21.5	18	18	18

Source: Company data, Nomura estimates

Exhibit 37. State Bank of India — balance sheet

Year-end 31 Mar (INRmn)	FY07	FY08	FY09E	FY10E	FY11E
Assets					
Cash	25,301	32,203	47,023	54,547	62,728
Money market and ST assets	176,486	102,167	335,877	389,618	448,061
RBI + bank balances	317,896	540,293	538,045	618,698	706,409
Total investments	1,491,489	1,895,013	2,442,794	2,938,466	3,286,172
Advances	3,373,365	4,167,682	5,126,249	5,741,399	6,602,608
Fixed assets	28,189	33,735	25,854	25,854	25,854
Other assets	252,923	444,170	510,796	587,415	675,527
Total assets	5,665,649	7,215,263	9,026,638	10,355,997	11,807,360
Gross NPLs	99,982	128,373	157,547	243,156	317,794
Net NPLs	52,577	74,243	99,025	149,035	182,678
Slippages to last year's loans	1.90%	2.30%	2.70%	3.30%	3.00%
Liabilities					
Equity capital	5,263	6,316	6,316	6,316	6,316
Reserves (excluding revaluation reserves)	307,723	484,012	561,202	627,662	705,622
Shareholders' funds	312,986	490,327	567,517	633,977	711,937
Deposits	4,355,211	5,374,039	6,717,549	7,792,357	8,961,211
Borrowings (including subordinated debt)	397,033	517,274	566,000	566,000	566,000
Other liabilities	600,423	833,623	1,175,571	1,363,663	1,568,212
Total liabilities	5,665,649	7,215,263	9,026,638	10,355,997	11,807,360

Source: Company data, Nomura estimates

Exhibit 38. State Bank of India — key ratios

Year-end 31 Mar	FY07	FY08	FY09E	FY10E	FY11E
Growth rates: (%)					
Assets	14.7	27.4	25.1	14.7	14
Loans	28.9	23.5	23	12	15
Deposits	14.6	23.4	25	16	15
Revenues	-5.2	22.7	26.6	8.5	14.7
Operating expenses	0.8	6.6	26	2.7	10.2
Operating profit	-11.5	43.5	27.2	14	18.6
Net profit	3.0	83.2	37.7	-11.4	13.4
EPS	3.0	83.2	14.7	-11.4	13.4
Profitability measures (%)					
Net interest margin	3.0	2.8	3	2.7	2.8
Free funds	0.6	0.5	0.8	0.9	0.9
Effective tax rate	39.7	34.9	33.6	33	33.3
RoA	0.9	1.04	1.14	0.85	0.84
RoE	15.4	16.7	17.5	13.6	13.8
Core RoE	14.1	13.9	16.2	12.9	13.3
Return on RWAs (RoRWAs)	1.4	1.5	1.5	1.1	1.1
Efficiency measures (%)					
Cost /income	54.2	49.1	48.8	46.2	44.4
Cost/assets	2.2	2	2	1.7	1.6
Staff cost/assets	1.5	1.2	1.2	1	1
Asset quality measures (%)					
Gross NPLs	2.9	3	3	4.2	4.7
Net NPLs	1.6	1.8	1.9	2.6	2.8
Provisions/ Gross NPLs	54.1	60.6	47.1	50	55
Leverage & capital measures (%)					
Loan/deposit ratio	77.5	77.6	76.3	73.7	73.7
Equity/assets	18.1	14.7	15.9	16.3	16.6
Tier 1 CAR	8	9.3	8.5	8.6	8.2
Tier II CAR	5.3	4.6	4.1	4.4	4.5

Source: Company data, Nomura estimates

HDFC — building in historically high credit costs

Stock rating: REDUCE
Sector view: NEUTRAL
Ticker: HDFC IN
Price as of 09 March (INR): 1,256
Price target (INR): 1,015
Potential upside/downside: -19%
YTD price perf (Abs): -15%
YTD price perf (Rel): 0%

We initiate coverage of Housing Development Finance Corporation (HDFC) with a REDUCE rating. Our 12-month price target is INR1,015, which implies 19% potential downside. HDFC is among the best managed finance companies in India, in our view, with a sound management team, strong risk-management practices and a track record of strong earnings growth and superior asset quality. However, we believe that like the rest of the sector HDFC's earnings growth and asset quality will be affected by the economic slowdown. With pressure on borrower incomes and high property prices, we expect growth in home loans to decelerate to 20% by end-FY09 and further to 15% in FY10, much lower than the 27% p.a. growth over FY03-FY08. We also expect NPLs to rise from a low 1.01% of loans as at end December 2008 to 1.51% in FY10-FY11. Given HDFC's conservative lending practices and sound risk management, we expect the rise in NPLs to be slower than that in the rest of the financial sector. However, we do expect loan-loss provisions to rise sharply, exerting pressure on profit growth. As asset quality has never been an issue, HDFC's credit costs have been very low at just 3-7bp over FY03-FY08. With NPLs rising, we expect credit costs to rise to 25-30bp of loans in FY10-FY11. With slower asset growth, higher credit costs, benign margins and lower trading gains, we expect earnings to remain flat in FY10 on low 2% growth for FY09. We expect earnings to rebound to 18% y-y in FY11.

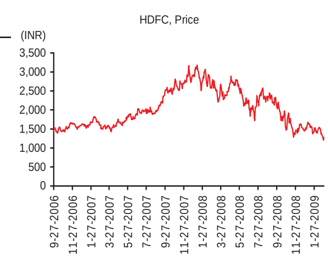
Our target multiple of 1.8x is based on a sustainable RoE of 19.4% and CoE of 13.3%. The sustainable RoE is lower than the FY08 RoE of 27.8%, largely on account of higher credit costs and lower trading gains.

Exhibit 39. HDFC — summary of key financials and market data

Key financials (INRmn)	FY08A	FY09E	FY10E
Op profit	33,415	32,714	31,274
Net profit	24,362	24,938	24,778
EPS	85.77	87.80	87.24
DPS	25.00	39.51	39.26
BVPS	421	466	508
Yield	2.0	3.1	3.1
P/BV	3.0	2.7	2.5
P/E	14.6	14.3	14.4

Key ratios	FY08A	FY09E	FY10E
RoE (%)	27.84	19.82	17.93
RoA (%)	3.2	2.7	2.3
Tier I CAR (%)	13.9	13.9	13.5
EPS growth (%)	38.2	2.4	(0.6)

Market data	
Ticker	HDFC IN
Market cap (US$mn)	7,280
Shares outstanding (mn)	284
Free float	98%



Source: Bloomberg

Source: Company data, Nomura estimates, Bloomberg for price chart

Investment summary

Consistent track record of earnings and superior asset quality: We believe HDFC remains one of the best managed Indian companies with a sound management team, strong brand name and consistent track record of high quality earnings.

Strong growth over the past five years: Over the past five years, HDFC's earnings have grown 29% p.a., loans at 27% and RoE has improved from 24% to 28%, that too in a period when competition in housing loans intensified. Asset quality remained superior to peers with gross NPLs for HDFC at 0.8-1% over FY03-FY08 as against 2-4% NPLs on housing loans for other banks. Sound risk-management practices and conservative lending practices have been responsible for HDFC's low NPLs, in our view.

Slowdown ahead: We expect HDFC's loan and earnings growth to slow down over the next few years, although the impact of the economic downturn on HDFC's earnings will likely be much less than on other banks given HDFC's robust balance sheet. We expect loan growth to slow to 15% in FY10 and earnings to remain flat in FY10 after low 2% growth in FY09E. Some slowdown was already seen in 3Q FY09 numbers with disbursement growth slowing to 18% and loan growth to 23%.

NPLs will rise to 1.5%: We expect NPLs to rise from 1.01% at end December 2008 to 1.5% in FY10-FY11. As a result, we expect credit costs for HDFC to rise from 7bp of loans in FY08 to 25bp in FY10.

Why our estimates are lower than consensus: Consensus estimates are building in 14-15% y-y growth in earnings for HDFC for FY10 as against our forecast of flat growth. We believe the key difference is in credit costs and loan growth. We believe consensus is still building in benign credit costs of 7-10bp as against our costs of 25bp of loans. We note that throughout HDFC's history, credit costs have always been 4-10bp, even in weak property cycles, especially FY96-FY00. Our rationale for building in higher credit costs this time round is that in the previous weak cycle, HDFC was a near monopoly in housing loans with over 55% market share and it could, therefore, choose its customers. There were smaller housing finance companies and foreign banks offering housing loans, but they lacked scale and focus. Banks entered the housing finance market in a big way only in FY02. With intense competition, increasing home loan sizes and rising stress on real estate developer balance sheets, we expect NPLs and credit costs to be higher than historical levels for HDFC although they will still be substantially lower than our 1-1.3% that we estimate for other banks.

Our price target for HDFC comprises INR650 for the housing business and INR365 for the subsidiaries. Our price target for the housing business is based on a sustainable RoE of 19.4%, which is lower than the FY08 RoE of 28%, due largely to higher credit costs. Our fair P/BV multiple for the core housing business works out to 1.7x P/BV for FY10 after adjusting for subsidiary valuations. The stock currently trades at 2.3x FY10E P/BV.

Earnings outlook

- HDFC's loan and disbursement growth has already slowed somewhat in 3Q FY09. Disbursement growth slowed to 18% in 3Q FY09 from an average of 28% in the preceding eight quarters and loan growth slowed to 24% against an average of 28% in the preceding eight quarters. We expect this trend to continue in FY10, since demand for new home loans has softened substantially since December 2008 with property prices and interest rates still high. We expect loan growth of 15% for FY10 and 16% for FY11.

- We expect NPLs to rise, although at a slower pace than the rest of the sector: We expect HDFC's NPLs to rise from the current 1% to 1.5% in FY10-FY11. In absolute terms, we expect NPLs to rise 54% in FY10 and then slow down to 16% y-y in FY11. In 9M FY09 HDFC's NPLs rose 34% over March 2008 levels.

- Credit costs will rise sharply although, although off a very low base: Since HDFC's asset quality has remained robust over the past several years, HDFC provides only 4-7bp of loans as credit costs each year. These low provisions are still more than regulatory requirements. Of the total cumulative provisions of INR4.9bn at end December 2008, HDFC has excess provisions of INR2.5bn.

  However, as NPLs rise, we expect provisioning requirements to rise as well. In our view, HDFC will require provisions of 25bp of loans in FY10 and 30bp in FY11 to maintain provisioning cover close to the December 2008 level of 54%. The sharp rise in credit cost from 7bp to 25bp will exert pressure on earnings growth, in our view.

Exhibit 40. Movement in NPLs

	FY07	FY08	9M FY09	FY09E	FY10E	FY11E
Gross NPLs	5,338	6,210	8,372.47	9,636	15,211	17,645
% to total loans	0.92	0.84	1.01	1.10	1.51	1.51
Gross NPLs on individual loans	4,297	5,128	na	7,148	11,988	13,906
Gross NPLs (%)	1.15	1.06	na	1.20	1.75	1.75
Gross NPLs on non retail loans	1,042	1,082	na	1,402	3,224	3,739
% to total loans	0.51	0.42	na	0.50	1	1
Cumulative provisions	4,097	4,703	4,980	5,190	6,956	9,404
Net NPLs	1,242	1,507	3,392	4,446	8,256	8,242
% of total loans	0.22	0.21	0.41	0.51	0.82	0.71
Total	**565,124**	**729,979**	**828,957**	**875,975**	**1,007,372**	**1,168,551**

Source: Company data, Nomura estimates

- Some margin contraction likely: We expect spreads on housing loans (calculated on balance sheet averages) to contract by 25bp from current levels to 2.55% in FY10.

- **Contribution from trading gains will continue to fall:** HDFC has non-strategic equity investments in a wide range of listed and unlisted companies that account for 3% of its assets. In addition, 3% of the balance sheet has been invested in subsidiaries and associates, including HDFC Bank. HDFC booked significant trading gains last year mainly from the sale of its equity stake in its business process outsourcing centre. While trading gains were unusually high at 23% in FY08, even over FY05-FY07 treasury gains were fairly high ranging at 14-17% of operating profit. We have forecast trading gains below 5% of operating profit over FY09-FY11.

- Overall, we expect net profit growth to remain flat in FY09 and rebound 19% y-y in FY10.

Price target

We value the core business at INR650 and subsidiaries at INR365, which gives us our consolidated fair value of INR1,015. We have valued the core business on a sustainable RoE of 19.4% and CoE of 13.3%, which yields a P/BV multiple of 1.7x. We have valued life insurance at 12x FY10E NBAP. We have valued HDFC's stake in its asset management company at 6% of equity funds and 2% of debt funds.

The table below explains the calculation of our target P/BV multiple for the core business.

Exhibit 41. HDFC — price target derivation

	FY08	Sustainable
NIM	3.5	3.7
Income from trading gains	0.1	1
Add other income	0.15	0.2
Total Other income	0.25	1.2
Operating expenses	0.48	0.4
Provisions	0.5	0.04
Pre-tax profit ex trading gains	2.775	4.5
Tax	1.3	1.2
PAT	1.94	3.2
Leverage	10	8.6
RoE	19.43	27.9
CoE	13.3	
g	4.5	
P/BV	1.7	
Book value	508	
Less investment in subsidiaries	125	
Net book value	383	
Fair value of the core business	650	
Value of subsidiaries	366	
Consolidated fair value	1,016	
Rounded off to	1,015	

Source: Company data, Nomura estimates

Exhibit 42. HDFC — value of subsidiaries

	% stake	Value of the firm	Value of HDFC's stake
HDFC Standard Life	73%	55,581	40,352
HDFC AMC	60%	20,280	12,168
HDFC Bank	19.30%	370,544	70,940
Total value		446,406	123,461
Value after 15% subsidiary discount			105,065
Value per share			366

Source: Company data, Nomura research

Valuing HDFC Standard Life: We value HDFC Standard Life as a sum of the values of its new and existing businesses. We have valued the new business at 12x FY10E NBAP. We believe growth for life insurers has slowed substantially in FY09. Over the past three months, the life insurance sector has seen negative growth rates in new premium income due to a sharp drop in the sales of unit-linked products. According to the latest data from the IRDA, in January 2009, HDFC Standard Life's new premium income declined 46% y-y. For 11M FY09, y-y growth was modest at 13% compared to a strong 78% p.a. over FY05-FY08. With lower growth rates factored in for the new business, consensus valuation multiples for life insurance companies have contracted from 23-25x at their peak in January 2008 to 10-14x at present. We have forecast a 5% decline in premium income in FY09, 5% growth in FY10 and a rebound to 30% y-y growth in FY11.

Exhibit 43. HDFC — value of the life insurance business

(INRmn)	FY10E
Value of new business	46,144
Value of in-force business	9,437
Value of whole business	55,581
Value of HDFC's 72.3% stake	40,185
Value per share	140

Source: Company data, Nomura estimates

Exhibit 44. HDFC — valuing the new business of HDFC Standard Life

(INRmn)	FY06	FY07	FY08	FY09E	FY10E
Total annualised premium	8,262	12,598	23,153	21,995	23,095
y-y (%)	110.5	52.5	83.7	-5	5
NBAP margin (%)	23	20	19	19	17
NBAP	1900.26	2519.6	4399.07	4069.14	3845.337
12x NBAP for the whole business					46,144

Source: Company data, Nomura estimates

Valuing HDFC Standard Life Asset Management: HDFC Asset Management manages funds worth INR676bn, according to NAV. Of its total AUM, 26% are equity assets; this is among the highest in the industry. We have valued equity AUMs at 6% of funds and debt at 2%. HDFC has a 60% stake in its asset management company.

HDFC Bank: HDFC currently owns 19% of HDFC Bank. Post warrant conversion, which will likely happen in FY10E, HDFC will own 23% of the bank.

Valuation and price performance

HDFC has outperformed the Sensex by 5% over the past six months. After deducting the face value of subsidiary investments from the book value and the fair value of subsidiaries from the price, the core housing business of HDFC trades at 2.3x (INR1,200-INR365)/(INR508-INR125). On unadjusted numbers, the stock trades at 2.5x FY10E P/BV as against its historical low of 1.6x and historical high of 4.1x. We see some downside from the current valuation since we expect a substantial slowdown in earnings growth and decline in marginal RoE.

Investment risks

- Lower-than-expected credit cost due to lower delinquencies is a key upside risk to our rating and earnings forecasts for HDFC.
- Higher-than-expected loan growth would also drive HDFC's earnings higher than our forecasts.
- If the government offers housing sops in the new budget expected post elections, housing disbursement growth would turn out to be higher than our expectation of 15% y-y growth for FY10E.
- A sharp decline in bond yields from current levels would also provide upside to our earnings estimates for HDFC.

Financials

Exhibit 45. HDFC — profit and loss

Year-end 31 Mar (INRmn)	FY07	FY08	FY09E	FY10E	FY11E
Interest income from housing	48,502	72,164	98,766	108,763	125,660
Fees & charges	686	632	788	907	1,052
Total revenue	58,963	88,323	109,833	120,255	137,763
Total interest expenses	36,668	51,429	72,721	80,910	90,278
Staff expenses	913	1,178	1,284	1,400	1,525
Establishment expenses	257	303	321	341	361
Other expenses	1,022	1,192	1,312	1,443	1,587
Non-interest expense	2,192	2,673	2,917	3,183	3,474
Depreciation	175	166	180	180	180
Provisions for contingencies	250	320	650	2,354	3,264
Total expenses	39,285	54,588	76,468	86,627	97,196
Pre-tax profit	19,678	33,735	33,364	33,628	40,567
Provision for income tax	3,950	9,350	8,426	8,850	11,277
Tax prov net of deferred tax	3,950	9,350	5,338	5,380	6,491
PAT	15,704	24,362	24,938	24,778	29,291

Source: Company data, Nomura estimates

Exhibit 46. HDFC — balance sheet

Year-end 31 Mar (INRmn)	FY07	FY08	FY09E	FY10E	FY11E
Share capital	2,530	2,840	2,840	2,840	2,840
Reserves	52,984	116,633	129,388	141,334	152,654
Shareholders' funds	55,514	119,473	132,228	144,174	155,494
Total loan funds	571,930	692,750	838,228	959,771	1,103,736
Current liabilities	18,632	19,069	22,883	27,460	32,952
Provisions	9,637	14,150	4,223	-354	-5,846
Current liab & prov.	28,269	33,220	27,106	27,106	27,106
Total liabilities	655,713	845,443	997,562	1,131,051	1,286,337
Assets					
Individual loans	373,624	483,781	595,663	685,013	794,615
Corporate loans	178,585	227,720	258,413	297,175	344,723
Other loans	12,914	18,479	21,899	25,184	29,214
Total loans	565,124	729,979	875,975	1,007,372	1,168,551
Subsidiaries & associates	12,425	29,526	31,192	35,376	37,376
Total equity investments	23,678	52,700	54,672	59,167	61,485
Investments	36,662	70,388	75,681	76,926	70,168
Current assets	50,566	41,524	42,355	43,202	44,066
Net block	2,131	2,085	2,085	2,085	2,085
Deferred tax asset	1,231	1,466	1,466	1,466	1,466
Total assets	655,713	845,443	997,562	1,131,051	1,286,337

Source: Company data, Nomura estimates

Exhibit 47. HDFC — key ratios

Year-end 31 Mar Growth Rates: (%)	FY07	FY08	FY09E	FY10E	FY11E
Loans	26	29	20	15	16
Assets	23	29	18	13	14
Borrowings	22	21	21	15	15
Net profit	25	55	2	-1	18
Per share, INR					
EPS	62	86	88	87	103
BVPS	219	421	466	508	547
Investment in subsidiaries	49	104	110	125	132
DPS	22	25	40	39	46
Profitability, %					
RoE	31	28	20	18	20
RoA	2.6	3.2	2.7	2.3	2.4
Tier I			14	14	13
Spread on housing loans	2.5	3	2.8	2.6	2.8
NIMs	2.5	3	4.2	3.1	3.2
Provisions to loans	0.04	0.04	0.07	0.23	0.28

Source: Company data, Nomura estimates

HDFC Bank — fairly priced

Stock rating: NEUTRAL
Sector view: NEUTRAL
Ticker: HDFCB IN
Price as of 09 March (INR): 799
Price target (INR): 840
Potential upside/downside: 5%
YTD price perf (Abs):-20%
YTD price perf (Rel):-5%

We initiate coverage of HDFC Bank with a NEUTRAL rating and a 12-month price target of INR840. We expect HDFC Bank's profit growth to moderate to 19% in FY09-11E, from 30% in FY05-08, still the strongest earnings growth among the Indian banks we cover. We estimate EPS growth of 16% over FY09-11E, given the pending dilution from warrants in FY10E. Our price target for HDFC Bank is based on 1.8x FY10E P/BV, which is lower than its mean valuation of 3.2x in the past two years and its trough valuation of 2.2x. The bank currently trades at 1.8x FY10E P/BV, making it the most expensive bank stock in India and in the region. Historically, the bank has traded at a significant premium to its peers, due to its high and consistently strong earnings growth of 30%, sound management team, strong loan loss cover and a strong deposit franchise. As we expect earnings growth to slow and NPL to rise sharply, we see limited potential upside to the stock price from the current level. We note that despite a slowdown in earnings, HDFC Bank will be the only bank in our universe that will likely deliver healthy double-digit growth, based on our estimates.

- NPL to rise with high exposure to small business and retail. We expect HDFC Bank's NPL to rise sharply by 4.5x over the level of March 2008, likely to be driven by the bank's high exposure to retail loans and the small business segments.

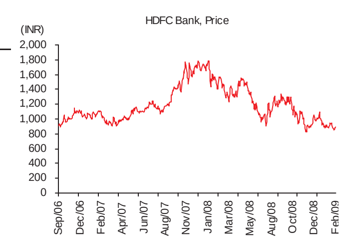
- Healthy tier-I and we do not expect equity dilution until FY11. We expect HDFC Bank's tier-I to remain healthy at 8.4% until FY11E. We believe the bank is adequately capitalised to support 25% asset growth over the next two years. The bank has the option of cutting dividends to preserve capital.

Exhibit 48. HDFC Bank — summary of key financials and market data

Key financials (INRmn)	FY08A	FY09E	FY10E
Op profit	41,433	55,576	68,137
Net profit	17,364	24,029	28,887
EPS	41.10	56.54	64.05
DPS	8.50	8.50	8.50
BVPS	324	364	454
Yield	1.1	1.1	1.1
P/BV	2.5	2.2	1.8
P/E	19.4	14.1	12.5

Key ratios	FY08A	FY09E	FY10E
RoE (%)	18.14	17.83	16.07
RoA (%)	1.3	1.3	1.2
Tier-I CAR (%)	10.3	9.3	8.9
EPS growth (%)	4.1	37.6	13.3

Market data	
Ticker	HDFCB IN
Market cap (US$mn)	6,879
Shares outstanding (mn)	422
Free float	78%



Source: Company data, Nomura estimates, Bloomberg for price chart

Investment summary

- Earnings growth set to slow. We expect HDFC Bank's net profit to rise 20% in FY10 and 18% in FY11, slower than the 30% CAGR over FY05-08E. We believe the earnings slowdown will be driven by lower loan growth of 25% in FY09-11E, from 35% in FY05-08, lower net interest margins (NIM) of 4.2% in FY10 and 4.1% in FY11 (compared with 4.4% currently) and high loan loss provisions of 1.9% of loans, due to rising NPL.

- We expect loan growth to moderate to 25% from 35%. We expect loan growth to slow to 25% in FY10-11, from 35% in FY05-08. HDFC Bank's loan growth has been faster than the sector, due to its strong brand franchise and sound distribution strategy. Retail loans, including unsecured loans and loans to small businesses, have been the key drivers of this growth. With a slowdown in both these segments, overall loan growth is likely to be slow.

- We expect a sharp rise in NPL. Given the aggressive loan growth over the past few years, we expect the bank's NPL to rise rapidly by 3x during December 2008-March 2011. We expect the bank's gross NPL to rise from 1.9% currently to 3.3% of loans by FY11.

- Merger benefits to flow in over the next two years. HDFC Bank and Centurion Bank merged in April 2008. We expect the merger benefits from Centurion Bank branches to emerge in the next two years.

- Equity dilution unlikely until FY11E. HDFC Bank's equity capital expanded 31% y-y in FY09. The issue of American Depository Receipts (ADRs) increased its equity capital by 11% and the merger with Centurion bank increased the equity capital by 20%. We expect further 6.8% dilution in FY10, from a possible warrant conversion by HDFC following the Centurion Bank merger, which would put the total dilution at close to 27%. Therefore, the effective equity dilution is 38% over the past 18 months. With a strong capital base and slowing growth, we believe HDFC Bank needs no fresh capital over our forecast period. We estimate that its tier-1 CAR, which was at 9.7% as of end-December 20008, will fall but still remain healthy at 8.4% in FY11, supporting our forecast growth of 25% in assets.

- HDFC Bank remains the best managed bank. HDFC Bank remains the best managed bank in India, in our view, with a sound management team, consistently strong earnings growth of 30% over the past six years, amongst the best asset quality in the sector with a NPL ratio of 0.4%, the highest margins in the sector at 4.4% versus the sector average of close to 3% and among the highest proportion of fees to total assets at 1.8%. We believe HDFC Bank's high margins and high provisioning cover provide a good cushion to absorb future asset quality pressures. This is why although we expect its earnings growth to decline, we still believe it will be healthy at 20% and higher than other banks.

Price target derivation

Our price target of INR840 is based on 1.8x FY10E P/BV. We have used a RoE of 20%, a CoE of 13.3% and a growth rate of 5.5%. At the current level, we see limited potential upside to the stock, given slowing loan and earnings growth, and rising asset quality risks.

Exhibit 49. HDFC Bank — fair P/BV calculation

(%)	FY08	Target
Net int inc/assets	4.7	4.0
Non-int inc/assets	1.8	1.7
Non-oper profits /assets	0.2	0.1
Opex / assets	3.3	2.3
Oper profits/assets	3.4	3.5
Provisions/assets	1.3	1.3
(1-tax rate)	69.7	67.0
RoA	1.4	1.5
Assets/equity (x)	12.5	13.5
RoE	17.7	19.9
Risk free rate		5.5
Risk premium		6.0
Beta		1.3
CoE		13.3
g		5.5
Target P/BV		1.8
BVPS (INR)		454
Target price of standalone bank, INR		839
Likely Impairment for foreign banking subsidiaries		
Fair value of subsidiaries		-
Total fair value		839
Rounded off (INR)		840

Source: Company data, Nomura estimates

Valuation and price performance

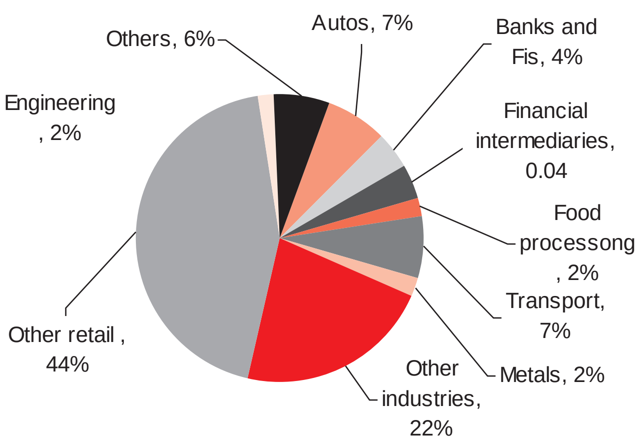
HDFC Bank trades at 1.8x FY10E P/BV, an historical low. Even after the recent correction, it remains the most expensive stock in the region. HDFC Bank has historically traded at a premium to other bank stocks due its strong franchise, consistent earnings growth of 30% over the past few years, sound management and a record of delivering high quality earnings growth even in cyclical downturns. HDFC Bank should prove to be a defensive holding, in our view. However, at current levels, we find limited potential upside to the stock price, as we see deterioration in earnings and asset quality. HDFC Bank has outperformed the Sensex by 18% over the past six months.

Loan mix and asset growth

Loan mix dominated by auto and small business loans

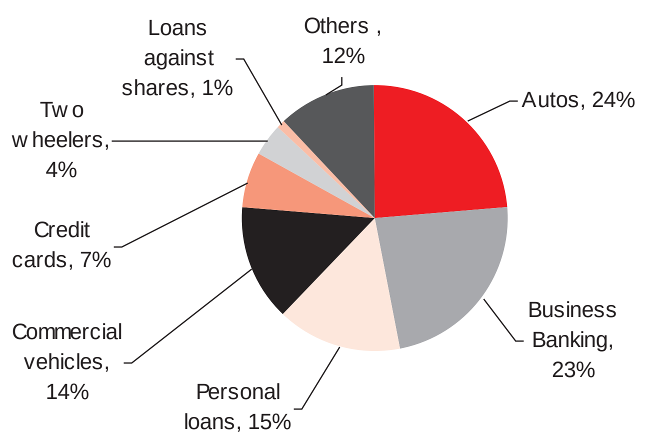
About 60% of HDFC Bank's total loans are retail loans. Business banking (which is loans to small businesses against collateral, mostly property) and auto loans are the largest individual lending segments, each accounting for 14% of total loans and around 23% of retail loans. From FY05-08, HDFC Bank's loans grew strongly at 35% y-y. In 3QFY09, HDFC Bank's loans grew 38% y-y. While y-y growth was due mainly to the merger, the q-q growth in 3Q FY09 was weak. On a q-q basis, total loans contracted 3.5% and retail loans grew at a modest 2% against the normalised 7% in 3Q FY09, as the bank focused on curtailing asset growth in order to improve margins in a tight liquidity environment. The bank ran down its corporate loan book and Centurion Bank's SME portfolio in 3Q FY09. The business banking segment remains the fastest-growing segment for HDFC Bank.

Exhibit 50. HDFC Bank – loan breakdown FY08



Source: Company data

Exhibit 51. HDFC Bank – retail loan breakdown



Source: Company data

Asset quality

NPL to rise 3x between now and FY11E

HDFC Bank's gross NPLs rose 14% q-q in 3QFY09, due to higher NPL on unsecured loans and the merger with Centurion Bank. We expect the rise in NPL to be sustained in the next two years. We believe with a slowing economy, HDFC Bank's NPL will grow from 1.9% of gross loans to 3.3% by FY11E. We expect NPL to build up in both the SME and business banking segments, which together account for approximately 36% of total loans. HDFC Bank's business banking portfolio at 23% of retail loans and 13% of total loans increased rapidly at 76% in December 2006-December 2008, much faster than the overall loan growth of 65% over the same period. The rapid growth in the business banking and unsecured segments will be the key driver of HDFC Bank's NPL, in our view.

Exhibit 52. HDFC Bank — movement in gross NPLs

(INRmn)	Gross NPL	Net NPL	Prov cover (%)	Slippages (%)	Loan loss provisions to loans (%)	Gross NPL (%)	Net NPL (%)
FY05	4,392	606	86	1.3	0.8	1.6	0.2
FY06	5,089	1,552	70	2.0	1.1	1.2	0.4
FY07	6,578	2,029	69	1.9	1.2	1.1	0.3
FY08	9,070	2,985	67	2.1	1.4	1.1	0.4
3QFY09	19,114	6,143	68	na	2.1	1.9	0.6
FY09E	23,248	9,067	61	2.7	1.7	2.1	0.8
FY10E	40,699	14,245	65	3.3	1.7	2.9	1.0
FY11E	58,779	20,573	65	3.0	1.9	3.3	1.2

Source: Company data, Nomura estimates

Investment risks

- Faster-than-expected loan growth would provide upside to our earnings estimates and price target for HDFC Bank.
- A sharp decline in bond yields from current levels would benefit HDFC Bank's earnings.
- Lower delinquencies would also provide upside to our earnings for HDFC Bank.
- Similarly, slower-than-expected loan growth, higher-than-expected delinquencies and increases in bond yields would likely be key downside risks to our earnings and price target for HDFC Bank.

Financials

Exhibit 53. HDFC Bank — profit and loss

Year-end 31 Mar (INRmn)	FY07	FY08	FY09E	FY10E	FY11E
Interest Earned from Advances	53,179	83,377	130,648	152,069	175,967
Interest Earned from Investments	23,011	31,709	42,692	60,776	78,156
Others	2,975	3,134	2,143	2,202	2,841
Total Interest Income	79,165	118,220	175,484	215,046	256,964
Interest expense	38,784	60,408	96,550	118,879	139,015
NII	40,381	57,812	78,934	96,167	117,949
Treasury Income	(672)	1,640	1,750	750	750
Non Interest Income	19,569	27,899	33,990	40,320	50,010
Total Income	98,734	146,119	209,474	255,366	306,974
Operating Expense	31,266	44,278	57,348	68,350	83,880
Operating Profit	28,683	41,433	55,576	68,137	84,080
NPA Provisions	7,314	11,861	16,724	23,162	32,195
Investment Provisions	(60)	(868)	-	-	-
Total Provisions	10,460	16,445	19,555	25,405	33,929
PBT	18,223	24,988	36,020	42,732	50,150
Tax Provisions	5,595	7,624	11,991	13,845	16,048
PAT	12,628	17,364	24,029	28,887	34,102
EPS	40	41	57	64	76
BVPS	239	324	364	454	520
DPS	7.0	8.5	8.5	8.5	8.5

Source: Company data, Nomura estimates

Year-end 31 Mar (INRmn)	FY07	FY08	FY09E	FY10E	FY11E
Capital	3,194	4,220	4,250	4,512	4,512
Reserves & Surplus	73,287	111,428	150,239	200,500	230,115
Deposits	831,617	1,245,851	1,694,357	2,067,116	2,583,895
Borrowings	37,463	54,098	68,965	86,283	108,856
Other Liabilities	153,977	190,338	237,922	297,403	371,754
Total	1,101,104	1,625,055	2,155,144	2,654,862	3,298,659
	FY07	FY08	FY09E	FY10E	FY11E
Cash & Bank Balances with RBI & Others	61,544	143,642	87,690	81,918	114,480
Balances at short & call notices	43,816	27,202	86,206	79,646	98,960
Advances	581,661	807,729	1,100,633	1,372,004	1,717,785
Investments	351,798	569,428	787,876	1,012,887	1,240,270
Fixed Assets	13,040	16,151	16,610	17,052	17,538
Other assets	49,245	60,903	76,129	91,355	109,626
Total Assets	1,101,104	1,625,055	2,155,144	2,654,862	3,298,659

Source: Company data, Nomura estimates

Exhibit 54. HDFC Bank — key ratios

Growth ratios, %	**FY07**	**FY08**	**FY09E**	**FY10E**	**FY11E**
Advances	40	39	36	25	25
Deposits	28	50	33	22	25
Assets	30	48	33	23	24
RWAs	35	55	33	22	22
Provisioning	23	57	19	30	34
Core operating profits	35	44	34	23	23
PAT	32	37	38	20	18
Profitability ratios, %					
NIM	4.4	4.5	4.4	4.2	4.1
RoAA	1.3	1.3	1.3	1.2	1.2
RoAE	18.4	18.1	17.8	16.1	15.5
Cost-Income ratio	52.2	51.7	50.8	50.1	49.9
C-D ratio	69.9	64.8	65.0	66.4	66.5
Capital position, %					
Equity / assets	7.0	7.2	7.2	7.7	7.1
CAR	11.8	13.0	12.4	11.8	10.6
Tier I	8.6	10.3	9.3	8.9	8.4
Tier II	3.2	2.7	3.1	2.9	2.2

Source: Company data, Nomura estimates

ICICI Bank: no positive catalysts

Stock rating: NEUTRAL
Sector view: NEUTRAL
Ticker: ICICIBC IN
Price as of 09 March (INR): 263
Price target (INR): 295
Potential upside/downside: +12%
YTD price perf (Abs): -41%
YTD price perf (Rel): -26%

We initiate coverage of ICICI Bank with a NEUTRAL rating and a 12-month price target of INR295, which implies potential upside of 12%. We have valued the core business at 0.6x P/BV using sustainable RoE of 10% and subsidiaries at INR135. A severe slowdown in the life insurance business has caused valuation multiples and consensus growth forecasts for life insurance to contract sharply. ICICI Bank's stock price has corrected sharply, underperforming the BSE-30 Index by 24% over the past 12 months and 21% over the past six months making it the most inexpensive banking stock under our coverage. However, we do not see any potential upside for the stock since we believe an earnings revival is unlikely in the next few quarters. Lingering concerns on international business, negative news flow on specific loan accounts and low RoEs are the key negative drivers for the stock in our view.

Loan growth to remain weak even in FY10E: ICICI Bank has not increased its loans in 9M FY09. We believe the outlook for loan growth remains bleak with a sharp slowdown in economic activity. We forecast loan growth at a modest 5% for FY10 on already flat growth in FY09E.

NPLs to rise 2x between now and FY11E: ICICI Bank's NPL cycle began faster than the sector driven largely by higher defaults in the unsecured personal loan segment. We expect NPLs to continue to grow at 35% p.a. over the next two years, driven by defaults on SME and retail loans.

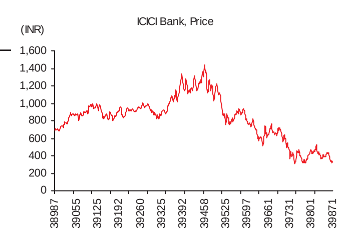
Modest earnings growth: We expect ICICI Bank to post only 2% earnings growth in FY10E, driven by slower loan growth and higher NPLs.

Exhibit 55. ICICI Bank — summary of key financials and market data

Key financials (INRmn)	FY08A	FY09E	FY10E
Op profit	79,607	91,267	100,575
Net profit	41,577	39,144	39,955
EPS	37.4	35.2	35.9
DPS	11	10	9
BVPS	418	436	451
Yield (%)	4	4	3
P/BV	0.6	0.6	0.6
P/E	7.0	7.5	7.3

Key ratios	FY08A	FY09E	FY10E
RoE (%)	11.7	8.2	8.1
RoA (%)	1.1	1.0	1.0
Tier I CAR (%)	11.8	11.6	10.8
EPS growth (%)	8.0	(5.9)	2.1

Market data	
Ticker	ICICIBC IN
Market cap (US$mn)	5,974
Shares outstanding (mn)	1,113
Free float	95%



Source: Company data, Nomura estimates, Bloomberg for price chart

Investment summary

Loan and earnings growth set to remain subdued in FY10: We see another weak year for ICICI Bank in FY10; we expect modest loan growth of 5% and low 2% earnings growth on slowing economic growth. We expect credit costs and NPLs to continue to rise.

Contrary to sector trends, we believe margins will expand in FY10: With the bank slated to re-price its bulk deposits (which form a significant 47% of total deposits) at lower rates over the next seven to nine months, we see potential upside to ICICI Bank's margins. We expect NIMs to improve to 2.7% in FY10E from the current 2.4%. However, we expect 4Q FY09E NIMs to be under pressure due to lower yields on priority loans, excess balance sheet liquidity and no major repricing of deposits in the quarter.

We expect ICICI Bank's loans to grow only 5% in FY10 on an already slow FY09. ICICI Bank's loan mix is dominated by retail loans, which form 54% of total loans, followed by international loans, which form 24% of the loans of the standalone bank as of end-December 2008. Loan growth during 9M FY09 declined 1.4% y-y for the standalone bank and is a low 3% for the consolidated entity. We expect the slowdown to be sustained in 4Q FY09 and FY10. According to company data, ICICI Bank's loans grew a rapid 38% p.a. over FY03-FY07 driven by strong growth in retail and international operations. Retail loans grew 60% p.a. during the same period. Thereafter, ICICI Bank followed a conscious strategy of going slow on retail loans especially small-ticket personal loans and SMEs to control credit quality and improve margins. As a result, loan growth in FY08 slowed to 15% p.a. with retail loan growth slowing sharply to 3% y-y. Loan growth failed to recover in 9M FY09 given the general economic slowdown that has affected growth in retail loans and the weak global outlook that has affected the international loan book.

Lingering concerns on international operations: International loans have been the fastest-growing segment for ICICI Bank. Overseas loans, which formed 34% of ICICI Bank's consolidated book at end-December 2008 and 26% of the standalone loan book, grew 37% y-y in 9M FY09, which was much higher than the bank's total loan growth of 3%. Pressure on NIMs due to high borrowing costs, the weak global outlook and the risk of MTM losses on the international investment portfolio are key risks to the bank's international operations.

Well capitalised: With its current Tier-I at a high 12.1%, ICICI Bank has the highest CAR among the banks we track. The CAR is likely to remain healthy over the next two years since we expect modest asset growth.

Our price target does not offer any potential upside: We have valued ICICI Bank's core business at 0.7x P/BV and subsidiaries at INR135. ICICI Bank has invested approximately INR46bn in its overseas banking subsidiaries, to which we have assigned zero value. Investors remain concerned that ICICI Bank could see further write-downs to loans and investments in overseas subsidiaries given the weakening global outlook. We have assumed various loss ratios for different categories of assets at ICICI's overseas subsidiaries in the UK, Canada and Eurasia. We have built in 13% additional write-downs to assets in UK, 4% for Canada and 15% for Eurasia. The total works out to INR45 per share post-tax, which we have deducted from our fair value.

We have valued life insurance at 12x one-year forward new business profit, asset management at 6% of equity funds and 2% of debt funds, ICICI Ventures at 12x one-year forward earnings and general insurance and ICICI Securities at 10x one-year forward P/E. We have applied a 15% subsidiary discount to arrive at our final consolidated subsidiary value.

Valuation methodology

Our price target of INR295 comprises INR206 for the parent bank, write downs of INR45 per share for the overseas banking subsidiaries and INR135 for non-banking subsidiaries.

Valuing the core banking business at 0.6x P/BV

We value the core banking business using the Gordon Growth model at 0.6x P/BV. Our fair RoE estimate for ICICI Bank at 10% is lower than the CoE but is still higher than ICICI Bank's reported RoE of 8.3% for 9M FY09. ICICI Bank's RoE has ranged from 8.3% to 13.3% over FY07 to 9M FY09, lower than the CoE for these years, due to frequent equity dilutions, heavy investment in subsidiaries which are yet to turn around and pressure on the profitability of the core business due to high cost of funds and rising NPLs. The key difference between the RoE reported for FY08 and our target RoE is our assumption of a higher credit cost of 1.3% as against the 0.8% reported in FY08. We have also assumed higher leverage in our target RoE as ICICI Bank is well capitalised to expand when the opportunity is right. We have assumed sustainable growth of 4.5% for ICICI Bank.

To calculate CoE, we have assumed a risk-free rate of 5.5%, an equity risk premium of 6% and a beta of 1.4x. Our CoE works out to 13.6%.

We have applied our fair P/BV multiple to the book value of the standalone bank after deducting investments in subsidiaries, which we have valued separately.

Valuing overseas banking subsidiaries: zero value for existing investments plus additional impairment of 7% on total foreign banking assets

We have assigned zero value to ICICI Bank's cumulative investments of US$1bn in overseas banking subsidiaries. Further, since the global outlook is deteriorating we have assumed various loss ratios on different categories of assets of the bank's international subsidiaries. The total impairment works out to 13% of the UK balance sheet, 4% of the Canada balance sheet and 15% of the Eurasia balance sheet. The combined impairment works out to 7% of total assets. We have deducted INR45 as post-tax impairment from our consolidated fair value to account for potential further write-downs at overseas banking subsidiaries.

Exhibit 56. ICICI Bank — derivation of price target

(%)	FY08	Target
Net int inc/assets	2.0	2.3
Non-int inc/assets	2.3	1.8
Non-oper profits /assets	0.0	-
Opex / assets	2.2	1.7
Oper profits/assets	2.1	2.4
Provisions/assets	0.8	1.3
(1-tax rate)	75.2	67.0
Minorities/assets		
RoA	1.1	0.7
Assets/equity (x)	10.5	13.5
RoE	11.7	9.9
Risk free rate		5.5
Risk premium		6.0
Beta		1.4
CoE		13.6
g		4.5
Target P/BV		0.6
BVPS, INR, FY10E		451
Less investment in subsidiaries		107
Net BVPs		344
Target price of standalone bank, INR		206
Less likely impairment of foreign banking subsidiaries		45
Value of core banking business		161
Fair value of subsidiaries		135
Total fair value		295
Rounded off to, INR		295

Source: Company data, Nomura estimates

Exhibit 57. ICICI Bank — international assets and estimated impairment

(INRbn)	Total assets	Impairment	% impairment
UK	373.2	49.2	13%
Canada	319.2	13.6	4%
Eurasia	30.5	4.5	15%
Total	722.8	67.2	9%
Post tax	722.8	52.4	7%
Per share		46.54	
Rounded off to		45	

Source: Company data, Nomura research

Exhibit 58. ICICI Bank — breakdown of overseas assets and possible markdowns

	Dec-08	% to total	% mark downs	Provisions
UK (US$bn)				
Cash	1.2	16	0	-
Loans and advances	2.7	36	5	0.1
Bonds of FIs	2.4	31	30	0.7
Asset backed securities	0.5	6	15	0.1
India linked	0.5	6	20	0.1
Other 'assets	0.4	5	0	-
Total assets	7.6	100		1.0
		372.4		49.2
% impairment to total assets				**13**
Canada (US$bn)				
Cash and liquid securities	1.3	20	0	-
India linked notes	0.195	3	30	0.1
Federally insured mortgages	1.105	17	0	-
Loans to customers	3.575	55	5	0.2
Asset backed securities	0.13	2	30	0.0
Other assets	0.195	3	0	-
	6.5	7	0	0.3
% impairment to total assets				**4**
Eurasia (INRmn)				
Cash and liquid securities	851	3	0	-
Minimum reserve deposit	303	1	0	-
Total placements with banks	11,410	37	0	2,424
of which				
Largest 30 Russian banks	4,603	15	30	1,381
OECD banks	3,161	10	15	474
Other Russian banks	1,299	4	30	390
Other foreign banks	598	2	30	179
Total loans and deposits	9,661	32	30	2,424
Other Nostro	844	3	0	-
Overnight placements	905	3	0	-
Loans to customers	11,931	39	7	835
Financial instruments at fair value	1,324	4	-	-
AFS securities	4,376	14	29	1,260
Russian government federal bonds	150	0	30	45
Volgograd municipality	81	0	30	24
Corporate bonds	3,537	12	30	1,061
Bonds issued by banks	431	1	30	129
Promissory notes	177	1	-	-
Property and equipment	87	0	-	-
Deferred tax	74	0	-	-
Other assets	124	0	-	-
Total	30,480	100		4,519
% impairment to total assets	**0**			**15**

Source: Company data, Nomura research

Exhibit 59. ICICI Bank — value of subsidiaries

(INRmn)	% stake	Value of ICBK's stake	Value of full business	Comments
Life insurance	74%	116,580	157,541	12x NBAP one-year forward
I sec	100%	8,404	8,404	10x one-year forward P/E
ICICI Ventures	100%	20,448	20,448	12x FY10 P/E
General Insurance	74%	24,115	32,588	10x one-year forward P/E
Asset management company	51%	8,912	17,475	2% of debt funds and 6% of equity funds
Total value		178,460	236,456	
No of shares		1,127	1,127	
Total value per share		**158**	**210**	
Value per share after subsidiary discount of 15%		135		

Source: Company data, Nomura estimates

Valuing life insurance: We have valued life insurance at INR135bn for the new business and INR22bn for the existing business, which yields a total value of INR157bn. The value for ICICI Bank's 74% stake in FY10E works out to INR117bn. We have valued new business at 12x one-year forward new business profit.

Valuing new business: After growing rapidly at 66% p.a. over FY05-FY08, ICICI's life insurance premium has slowed substantially in FY09 in line with industry trends. Over the past three months, the life insurance industry has been witnessing a y-y drop in new business sales. The slowdown in the life insurance industry has been driven by a sharp drop in new sales of unit-linked products (80% of all product sales) owing to weak capital markets. New business sales declined 6% y-y for ICIC PruLife, 18% y-y for all private players and 54% for all players including LIC in 10M FY09, according to data released by the Insurance Regulatory Development Authority (IRDA), India.

We forecast 10% y-y decline in new premium for FY09 and 10% growth in FY10. We have assumed that new business margins will remain at the 9M FY09 level of 19% for full-year FY09 and then drop to 17% for FY10. We have valued the new business at a multiple of 12x, which is derived using specific growth rates for the next 10 years. We have also assigned value to the existing business but given the significant losses, and therefore zero accretion to reserves, the value for the existing business is low.

Exhibit 60. ICICI Bank — valuing new life business

	FY07	FY08	FY09E	FY10E
WRP (INRmn)	39,715	66,840	60,156	66,172
Forecast growth rate (%)	84	68	-10	10
NBAP Margin (%)	20	19.2	18.90	17.01
NBAP (INRmn)	8,810	12,540	11,369	11,256
12x NBAP for the whole business (INRmn)				135,069
Value of ICICI Bank's 74% stake (INRmn)				99,951

Source: Company data, Nomura estimates

Exhibit 61. ICICI Bank — deriving target multiple for new life business

Year	Growth	Base	Growth rate (%)	Discount rate	Discounting factor	Discounted value
0	FY09	0.9	0%	13.8	1	0.9
1	FY10	1.1	10%	13.8	1.1	0.97
2	FY11	1.4	30%	13.8	1.3	1.11
3	FY12	1.8	25%	13.8	1.5	1.21
4	FY13	2.1	15%	13.8	1.7	1.23
5	FY14	2.4	15%	13.8	1.9	1.24
6	FY15	2.7	15%	13.8	2.2	1.25
7	FY16	3.1	15%	13.8	2.5	1.27
8	FY17	3.6	15%	13.8	2.8	1.28
9	FY18	4	10%	13.8	3.2	1.24
10	FY19	4.4	10%	14.8	3.6	1.2
P/E multiple						12

Source: Company data, Nomura estimates

Exhibit 62. ICICI Bank — value of existing business

	FY03	FY04	FY05	FY06	FY07	FY08	Cumulative
NBAP (INRbn)	1	2	3.93	5.41	8.80	12.54	33.38
NBAP after unwind of discount (INRbn)							16.50
Add Equity capital (INRbn)							14.01
Less accumulated losses (INRbn)							8.04
Shareholders' funds (INRbn)							5.97
Value of existing business (B) (INRbn)							**22.47**
Value of ICICI Bank's 74% stake (INRmn)							**16.63**

Source: Company data, Nomura research

Exhibit 63. ICICI Bank — value of the whole life insurance business

(INRmn)	FY10E
Value of new business	135,069
Value of in force business	22,472
Total value of life insurance	157,541
Value of ICICI Bank's 74% stake	116,580

Source: Company data, Nomura estimates

Valuing asset management: ICICI Bank's asset management subsidiary manages assets worth INR518bn. We have valued the asset management business at 6% of equity funds and 2% of debt funds. The 9M FY09 earnings for the AMC contracted sharply from 0.75bn to INR0.3bn. We expect earnings to grow 12% in FY10.

We have valued general insurance and ICICI Securities at 10x one-year forward P/E and ICICI Ventures at 12x one-year forward P/E.

Financials

Asset growth and asset mix: ICICI Bank's asset mix is dominated by retail and international loans. Retail loans form 54% of the standalone book and 49% of the consolidated loan book. International loans are the next largest pie, accounting for 26% of standalone loans and 34% of consolidated loans. ICICI Bank slowed down its loan growth at end-FY08 to control the quality of its retail loan book after delinquencies started rising from 3Q FY07. After a CAGR of 38% over FY03-FY07, loan growth slowed to 15% in FY08 and further to a negative 1.4% in 9M FY09. Investors expected ICICI Bank's loan growth to revive in 2H FY09. However, loan growth failed to revive owing to the general economic slowdown. We expect loan growth to remain subdued in 4Q FY09 and in FY10. We expect loans to grow 5% in FY10 and then revive to 15% in FY10.

Branch expansion and control on operating expenses will be the key focus areas for the bank in a slow growth environment: The bank plans to continue with its rapid branch expansion to improve the share of its savings deposits. It currently operates 1,416 branches, up from 755 in March 2007. It plans to open another 580 branches over the next 12 months (it already holds licences for these). However, the bank is not planning any significant recruitment; instead, it plans to redeploy employees. So, we do not expect any major cost impact from the new branch additions over the next one year. The bank has initiated a major cost-control exercise over the past few quarters, which has shown positive results. Operating expenses declined 19% q-q due largely to these initiatives and to savings on marketing expenses as retail loan growth slowed.

Key earnings drivers

- We expect EPS to decline 6% in FY09E, 2% in FY10E and 20% in FY11E.

- We expect NIMs to expand 30bp to 2.7% in FY10 from the current 2.4%, as ICICI Bank expands its branch network and repays high-cost bulk deposits that form 47% of its total deposits over the next seven to nine months.

ICICI Bank's NIMs of 2.4% are lower than the sector average of 3% largely because of its lower-than-sector CASA ratio of 27% and a high proportion of bulk-term deposits. While ICICI Bank's CASA ratio improved from 26% in FY08 to 27% in FY09, it remains lower than that of other large private banks. Savings deposit growth was hurt in 3Q FY09 due to unfounded speculation that the bank's liquidity was under severe strain. We expect its CASA to improve to 31% by FY11 with the bank's rapid branch expansion. The bank's branch network doubled between March 2007 and December 2008 from 755 to 1,416 branches. The bank has licences to add 580 new branches over the next 12 months. Since it takes typically 12-18 months for a branch to break even, we expect the contribution from the branches added over the past 1.5 years to kick in over the next few quarters.

We expect growth in core fees to slow to 1% in FY09, 5% in FY10 and recover to 18% y-y in FY11. The slowdown in fees is expected to be in line with slower loan growth and lower revenues from third-party distribution as sales for mutual funds and insurance products slow.

- We expect operating expenses to fall from 2.2% of average assets in FY08 to 1.6% in FY09 and 1.7% in FY10.

- We expect NPLs to rise 45% in FY10 and 30% in FY11. While this is a sharp increase, the growth should still be slower than the sector's since ICICI Bank's NPL cycle started at end-FY07, while NPL formation for other banks should be significant in the forthcoming quarters. We forecast gross NPLs at 7.9% of loans, up from 3.7% in FY08 and 5.7% in FY09.
- We expect provisioning cover of 55% in FY10, as against 49% reported at end December 2008.
- We expect RoE to remain under 10% through our forecast period, which will be lower than the current CoE of 13.6%.
- We forecast Tier I CAR of 11.6% at end March 2009, 10.2% at end March 2010 and 9.8% at end March 2011. ICICI Bank's reported Tier I CAR was 12.1% at end December 2008. This is the strongest among the banks we cover. We believe ICICI Bank is very well capitalised with such a strong Tier I.

Asset quality

Exhibit 64. ICICI Bank — movement in NPLs

(INRbn)	FY07	FY08	3QFY09	FY09E	FY10E	FY11E
Collateralised	14	22	30	33	44	57
Non-collateralised	17	32	36	40	54	70
Total retail NPLs	31	54	66	72	98	127
Non retail NPLs	11	30	31	37	60	78
Gross NPLs	42	84	96	109	158	205
Sold to ARCIL	-	7	14	14	14	14
NPLs written off	-		16	16	16	16
Total NPLs including sold to ARCIL and written off	42	90	126	138	187	235
Specific provisions made through the P/L	15	23	10	39	45	46
General provisions made through the P/L	7	4	-	0	1	3
Cumulative specific provisions	22	41	40	49	81	108
Cumulative general provisions	7	12	12	12	13	13
Total provisions	29	53	52	61	93	121
Net NPLs	13	31	45	48	65	84
Retail loans	1,277	1,317	1,145	1,179	1,238	1,486
Other loans	682	940	980	996	1,046	1,150
Total loans	1,959	2,256	2,125	2,175	2,284	2,636
Gross Retail NPLs as % of retail loans	2.42%	4.09%	5.74%	6.13%	7.88%	8.53%
Total Gross NPLs as % of total loans	2.15%	3.70%	4.54%	5.01%	6.91%	7.79%
Total net NPls as % of net loans	0.68%	1.37%	1.95%	2.19%	2.84%	3.20%
Provisions made through the P/L as % of loans	0.80%	1.00%	0.50%	1.80%	2.00%	1.80%
Provisions as % of gross NPLs	52%	49%	41%	45%	51%	53%

Source: Company data, Nomura research

ICICI Bank's NPL cycle started from FY07, earlier than the sector, when the bank started seeing a fresh build-up of NPLs largely due to high growth in its retail loans since FY03 that started seasoning and also due to new RBI guidelines on bad debt recovery agents. ICICI Bank's NPLs grew 2.8x between March 2006 and December 2008 on account of higher slippages in unsecured personal loans. Gross NPLs rose 41% y-y in FY07, 99% y-y in FY08 and 33% YTD on a like-to-like basis in 9M FY09. As the NPL cycle has already started for ICICI Bank, the growth in new NPLs over 4Q FY09E-4Q FY11E will be slower than for the sector, but the base is already high.

We expect NPLs to grow 30% y-y for FY09 (after including an INR16bn write-off in 3Q FY09), 45% y-y in FY10 and 30% in FY11. Management had earlier indicated that NPLs would likely peak in 2Q FY09. However, with the economic slowdown setting in over the past two quarters, we expect NPL accretion to continue for the next few quarters. In addition to retail loans, we see NPLs from corporate loan accounts. While ICICI Bank's corporate loan exposure is lower than that of the sector, some of the bank's guarantees given to these corporates could be invoked, causing NPLs to rise. When guarantees are invoked non-fund based exposures are converted to fund-based exposures.

We expect ICICI Bank's bad loans to rise from 4.5% of total loans to 6.9% in FY10 and further to 7.8% in FY11. We believe the percentage level of NPLs will be higher than the sector average, and will be partly exaggerated by slower-than-sector loan growth. We expect net NPLs at 2.8% of net loans by March 2010 and 3.2% of net loans by March 2011.

Valuations and price performance

ICICI Bank trades at 0.6x FY10E P/BV. After deducting the fair value of subsidiaries from the share price and the par value of investments in subsidiaries from the total book value, the bank trades at 0.4x P/BV making it the least expensive stock in our coverage universe. The stock price has underperformed the BSE-30 Index by 25% over the past six months, which is the sharpest underperformance among banks we cover. The stock has underperformed other bank stocks on concerns about its international operations, negative newsflow on specific loan accounts and weak core operating results over the past four quarters.

Despite low valuations, we find limited upside to the stock price since we forecast that its RoE will remain below its CoE through FY11 and we do not see a turnaround in earnings, loan growth and asset quality until 2H FY11.

Investment risks

- Faster-than-expected loan growth would provide upside to our earnings estimates and price target for ICICI Bank.

- A decline in credit default spreads would lower borrowing costs for ICICI Bank's international operations and provide upside to our earnings.

- A sharp decline in bond yields from current levels would provide upside to our earnings estimates for ICICI Bank.

- Lower delinquencies would also provide upside to our earnings for ICICI Bank.

- Similarly, slower than expected loan growth, higher than expected delinquencies and increase in bond yields will likely be key downside risks to our earnings and price target for ICICI Bank.

Financials

Exhibit 65. ICICI Bank — profit and loss

Year-end 31 Mar (INRmn)	FY07	FY08	FY09E	FY10E	FY1lE
Interest earned	219,953	307,883	330,622	327,745	353,635
Interest expended	173,575	234,842	249,451	236,463	252,660
Net interest income	46,378	73,041	81,171	91,282	100,974
Fees and comm	50,120	56,053	56,745	59,577	70,629
Profit on sale of inv	10,140	18,777	3,000	2,500	2,500
Profit on foreign exchange transactions	5,204	1,102	1,157	1,319	1,503
Lease income	3,903	3,708	3,522	3,346	3,179
Others	-87	8,467	8,288	8,762	9,986
Noninterest income	69,280	88,107	72,712	75,504	87,797
Employee	16,168	20,789	19,506	20,872	22,333
VRS expenses	256	256	-	-	-
Other operating expenses	50,738	60,497	43,109	45,338	52,603
Operating expenses	66,906	81,542	62,616	66,210	74,936
Pre-provision profit (Operating profit)	48,752	79,607	91,267	100,575	113,836
Pre-provision profit excluding trading gains	38,612	60,829	88,267	98,075	111,336
Specific	14,950	23,374	39,074	44,927	46,267
General	7,310	4,258	2	1,032	2,630
Total loan loss provisions	22,260	27,632	39,076	45,959	48,897
Others	-	1,413	1,000	1,500	1,000
Provisions & contingencies	22,260	29,046	40,076	47,459	49,897
Pre-tax Profit	26,492	50,561	51,191	53,116	63,939
Tax	5,380	8,984	12,048	13,160	15,974
Net profit	21,112	41,577	39,144	39,955	47,965
EPS	34.6	37.4	35.2	35.9	43.1
DPS	10	10.7	9.9	9	9

Source: Company data, Nomura estimates

Exhibit 66. ICICI Bank — balance sheet

Year-end 31 Mar (INRmn)	FY07	FY08	FY09E	FY10E	FY10E
Assets					
Cash	20,666	28,478	8,800	8,976	10,412
RBI + bank balances	350,544	351,933	255,122	112,194	130,145
Government + other approved securities	673,680	750,310	712,504	729,251	838,788
Non-SLR investments	238,900	364,230	487,087	620,102	650,742
Total investments	912,580	1,114,540	1,199,591	1,349,353	1,489,530
Advances	1,958,660	2,256,160	2,175,252	2,284,014	2,636,248
Fixed assets	39,234	41,089	43,661	45,095	46,953
Other assets	164,896	205,751	236,614	248,444	260,867
Total assets	3,446,580	3,997,951	3,919,039	4,048,076	4,574,153
Liabilities					
Equity capital	8,990	11,127	11,127	11,127	11,127
Reserves (Excluding revaluation reserves)	234,140	453,575	474,868	490,373	512,130
Shareholders' funds	243,130	464,702	485,995	501,500	523,257
Deposits	2,305,100	2,444,310	2,224,322	2,243,877	2,602,897
Borrowings (including subordinated debt)	709,812	867,486	1,000,640	1,049,247	1,171,737
Other liabilities	188,235	221,452	232,525	253,452	276,263
Total liabilities	3,446,277	3,997,950	3,943,482	4,048,076	4,574,153

Source: Company data, Nomura estimates

Exhibit 67. ICICI Bank — key ratios

Year-end 31 Mar	FY07	FY08	FY09E	FY10E	FY10E
Growth rates (%)					
Assets	37.1	16.0	(2.0)	3.3	13.0
Loans	34.0	15.2	(3.6)	5.0	15.4
Deposits	39.6	6.0	(9.0)	0.9	16.0
Revenues	40.9	28.3	(4.5)	8.4	13.2
Fee & commission income	67.0	11.8	1.2	5.0	18.6
Other core fee income	25.4	5.4	(23.7)	3.5	9.2
Total fee income	38.0	17.2	0.6	4.7	16.8
Trading income	45.6	85.2	(84.0)	(16.7)	-
Operating expenses	33.8	21.9	(23.2)	5.7	13.2
Operating profit	50.1	35.5	14.6	10.2	13.2
Operating profit adjusted for trading gains	51.1	25.2	45.1	11.1	13.5
Net profit	22.5	33.7	(5.9)	2.1	20.0
Profitability measures (%)					
Net interest margin	2.0	2.2	2.4	2.7	2.8
RoA	1.0	1.1	1.0	1.0	1.1
RoE	13.4	11.7	8.2	8.1	9.4
RoE adjusted for trading gains	10.3	8.0	7.8	7.7	9.0
Return on RWAs (RoRWAs)	1.2	1.3	1.0	1.0	1.0
RoE ex subsidiary investments	14.1	11.5	9.1	9.1	10.8
Leverage & Capital Measures (%)					
Loan/deposit ratio	85.0	92.3	97.8	101.8	101.3
Equity/assets	7.8	9.5	12.0	12.4	11.9
Tier 1 CAR	7.4	11.8	11.6	10.8	9.7
Tier II CAR	4.4	2.2	4.8	4.8	4.5
Payout ratio (ie post g'will and below the line interest)	32.4	33.1	33.1	33.1	33.1

Source: Company data, Nomura estimates

Bank of India — weak earnings outlook

Stock rating: NEUTRAL
Sector view: NEUTRAL
Ticker: BOI IN
Price as of 09 March (INR): 181
Price target (INR): 175
Potential upside/downside: -3%
YTD price perf (Abs): -37%
YTD price perf (Rel): -22%

We initiate coverage of Bank of India with a NEUTRAL rating and a 12-month price target of INR175. We believe Bank of India has been among the fastest growing state banks, with net profit growth of 80% during FY05-08 and loan growth of 26%, driven by expanding margins, a well-hedged bond portfolio, higher fees and high recoveries. We expect earnings to decline 27% y-y in FY10E, driven by higher credit costs, lower trading gains, lower recoveries and pressure on margins. Our ROE of 11% assumes provisioning costs of 1.0% against the current 0.5%. Our fair ROE is substantially lower than the current ROE of 18%, largely due to lower credit costs and lower leverage.

We expect the bank to record loan growth of 15% in FY10E, which is lower than the 27% loan growth recorded during FY05-08, but higher than 12.5% for the sector, given its aggressive growth strategy. However, we believe, the higher growth will come with higher risks.

We expect earnings to decline significantly by 27% in FY10 as NIM contracts by 30bp y-y, trading gains decline to 6% of operating profit from 45% in 3Q FY09 and provisioning costs rise sharply.

Around 11% of the bank's operating profit comes from its international operations, which lacks visibility, in our view.

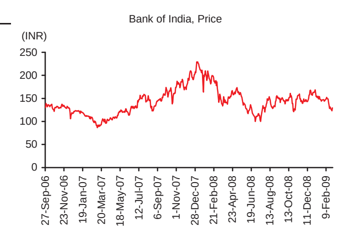
The stock is currently trading at 0.7x FY10E P/BV. We expect downside risks to the valuation multiple, as we expect earnings to decline significantly in FY10.

Exhibit 68. Bank of India — summary of key financials and market data

Key financials (INRmn)	FY08A	FY09E	FY10E
Op profit	37,012	53,680	53,700
Net profit	20,094	29,623	21,389
EPS	38.21	56.33	40.67
DPS	4.00	6.76	5.88
BVPS	168	216	250
Yield	2.1	3.6	3.1
P/BV	1.1	0.9	0.7
P/E	4.9	3.3	4.6

Key ratios	FY08A	FY09E	FY10E
RoE (%)	27.6	29.3	17.4
RoA (%)	1.3	1.5	0.9
Tier I CAR (%)	7.7	8.7	8.1
EPS growth (%)	66.1	47.4	(27.8)

Market data	
Ticker	BOI IN
Market cap (US$mn)	2,007
Shares outstanding (mn)	526
Free float	35%



Source: Bloomberg

Source: Company data, Nomura estimates, Bloomberg for price chart

Investment summary

Among the fastest growing banks

We believe Bank of India is one of the fastest growing state banks, with earnings growth of 80% y-y- during FY05-08. We believe the strong earnings growth was driven by loan growth of 27% through this period, improvement in NIM from 2.6% in FY05 to 3.2% currently, high recoveries of bad debts and high trading gains.

Loan growth to slow

We expect loan growth for the bank to slow to 15% in FY10 and 16% in FY11E, in line with a slowing domestic economy. While we expect loan growth to slow from 27% during FY05-08 and 31% in 9M FY09, it will still be higher as compared with other Indian banks, given Bank of India's aggressive growth strategy.

The bank's international operations accounted for 20% of loans, 13.5% of operating profit and 12% of net profit in 9M FY09.

We expect NIMs to decline to 2.9% in FY10-11 from 3.2% in FY08.

We expect trading gains to decline to 6% of operating profit in FY10E, from 45% of operating profit in 3Q FY09 and 12% in 9M FY09.

NPLs to rise

We expect the bank's NPLs to rise 3x between now and FY11. Like Union Bank of India, Bank of India's unseasoned SME loans are reasonably large at 76%. The proportion of SME loans is also high at 22%. In fact, the bank witnessed some pressure on asset quality even in 3Q FY09 when NPLs rose 12% q-q. We expect asset quality to continue to deteriorate.

Credit costs to increase

We expect credit costs to increase sharply to 1.1% of loans by FY11E from 0.65% in 3Q FY09. We expect provisioning cover to decline to 60% in FY10/11E from 78%, currently.

High government stake

The government holds a 65% stake in Bank of India. Although we believe the bank has enough leeway to raise fresh capital, we do not see the need to raise fresh capital through our forecast period, as we estimate the banks tier-I ratio at 8% for FY11E.

Chairman to retire

The chairman of the bank, Mr TS Narayansami, is due to retire in June 2009. He joined the bank in July 2007. The government will announce his successor closer to his retirement.

Price target

Our price target of INR175 is based on a target P/BV multiple of 0.7x. Our fair ROE of 11% is substantially lower than the reported ROE of 28% for FY08, due to the higher credit cost of 1% against 0.6% in FY08 and lower trading gains. At current levels, we do not see any upside to the stock price, as we expect earnings and asset quality to deteriorate.

Exhibit 69. Price target derivation for Bank of India

	FY08	Target
Net int inc/assets	2.6	2.6
Non-int inc/assets	0.7	0.7
Non-oper profits /assets	0.6	0.1
Opex / assets	1.7	1.5
Oper profits/assets	2.3	1.9
Provisions/assets	-	1.0
(1-tax rate)	57.8	67.0
RoA	1.3	0.6
Assets/equity (x)	22.0	18.0
RoE	27.6	10.9
Risk free rate		5.5
Risk premium		6.0
Beta		1.4
CoE		13.6
g		4.5
Target P/BV		0.7
BVPS, INR.		250
Target price of standalone bank, INR		175
Likely Impairment for foreign banking subsidiaries		
Fair value of subsidiaries		-
Total fair value		175
Rounded off to, INR		175

Source: Company data, Nomura estimates

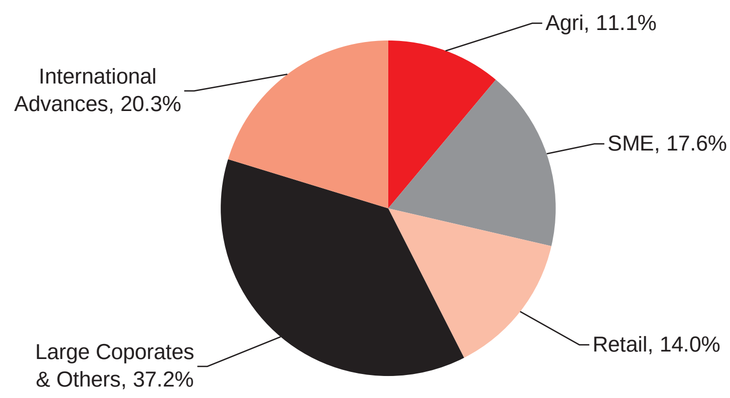
Valuation and price performance

The stock price has outperformed other banking stocks and the SENSEX by 35% over the past six months, driven by strong earnings and sound asset quality. As we expect earnings to decline by 28% in FY10E, we see limited potential upside to the stock price. The stock is currently trading at 0.7x FY09E P/BV which is at the lower end of its historical trading band.

Loan mix and NPLs

Corporate loans account for a large share (37%) of the bank's total loans, followed by international loans (20%), SME loans (18%) and retail loans (14%).

Exhibit 70. Bank of India's loan breakdown



Source: Nomura research

Corporate loans have grown the fastest over the past two years as seen below:

Exhibit 71. Bank of India — segment-wise loan growth

	FY06	% y-y	FY07	% y-y	FY08	% y-y	3QFY09	% y-y
Total loans	666,620	16.7	867,910	30.2	1,148,387	32.3	1,361,000	31.3
Domestic loans	540,230	23.7	698,110	29.2	913,880	30.9	1,085,000	27.9
Agri	90,200	29	106,640	18.2	131,580	23.4	151,000	24.9
SME	155,530	14.3	162,110	4.2	204,000	25.8	239,000	25.1
Retail	145,800	36.7	174,270	19.5	193,780	11.2	190,000	1.1
Mid and large corporates	148,700	18.3	341,270	129.5	502,910	47.3	506,000	57.9
International Advances	126,390	-4.9	169,800	34.3	234,050	37.8	275,690	27.3

Source: Company data

Given the rapid loan growth witnessed over the past few years, we expect gross NPL ratio to deteriorate sharply from 1.7% of loans in FY08 to 4.61% of loans by FY11. We expect slippages to increase sharply from 1.6% of loans to 3.0-3.3% of loans in FY10-11E.

Exhibit 72. Bank of India — movement in NPLs

	Gross NPLs	Net NPLs	Slippage	Prov / Loans	Provisioning cover	Gross NPLs, %	Net NPLs
	INR. MM	INR. MM	%	%	%	%	%
FY02	35,030	23,040	4.2	2.1	38.1	9.37	6.01
FY03	35,520	23,820	3.2	1.8	37.4	8.63	5.59
FY04	33,951	20,616	2.8	1.4	44.8	7.86	4.50
FY05	28,724	15,540	1.6	0.7	50.8	5.53	2.80
FY06	22,044	9,695	1.3	1.0	60.9	3.72	1.49
FY07	18,896	6,320	1.5	0.9	69.9	2.43	0.74
FY08	17,744	4,119	1.6	0.8	78.7	1.68	0.36
FY09E	25,534	8,937	1.8	0.6	65.0	1.80	0.64
FY10E	58,885	23,554	3.3	1.5	60.0	3.60	1.46
FY11E	89,100	35,640	3.0	1.3	60.0	4.61	1.87

Source: Company data, Nomura research

Investment risks

- Faster than expected loan growth will provide upside to our earnings estimates and price target for Bank of India.

- A sharp decline in bond yields from current levels will benefit Bank of India's earnings.

- Lower delinquencies will also provide upside to our earnings forecasts for the bank.

- Similarly slower than expected loan growth, higher than expected delinquencies and increase in bond yields will likely be key downside risks to our earnings and price target.

- Recovery in the international financial markets will benefit Bank of India's international operations.

Financials

Exhibit 73. Bank of India — profit and loss

Year-end 31 Mar (INRmn)	FY07	FY08	FY09E	FY10E	FY11E
Interest Income	89,363	123,552	163,018	184,501	208,093
Interest Expended	54,959	81,260	107,165	124,520	139,828
Net Interest Income	34,405	42,292	55,853	59,981	68,265
Other Income	15,630	21,169	28,401	26,441	28,647
Net Income	50,034	63,461	84,254	86,422	96,912
Operating Expenses	26,084	26,450	30,574	32,722	35,740
Operating Profit	23,950	37,012	53,680	53,700	61,172
Provisions	8,621	10,165	12,538	23,993	25,369
PBT	15,329	26,847	41,142	29,707	35,803
Tax	4,097	6,753	11,520	8,318	10,025
PAT	11,232	20,094	29,623	21,389	25,778

Source: Company data, Nomura estimates

Exhibit 74. Bank of India — balance sheet

Year-end 31 Mar (INRmn)	FY07	FY08	FY09E	FY10E	FY11E
Current Assets	174,055	177,174	183,270	231,365	253,640
Investments	354,928	418,029	470,282	517,311	569,042
Loans	849,359	1,134,763	1,401,433	1,611,648	1,901,744
Net Fixed Assets	7,895	24,261	27,059	26,734	26,384
Other Assets	30,133	34,073	37,480	41,228	45,351
Total Assets	**1,416,370**	**1,788,300**	**2,119,524**	**2,428,285**	**2,796,160**
Capital	4,881	5,259	5,259	5,259	5,259
Reserves & Surplus	54,072	100,635	126,098	143,871	165,512
Net Worth	58,953	105,894	131,357	149,131	170,771
Deposits	1,198,817	1,500,120	1,815,145	2,096,492	2,431,931
Borrowings	113,798	121,184	132,791	144,431	157,228
Other Liabilities & Prov.	44,801	61,102	40,231	38,231	36,231
Total Liabilities	**1,416,370**	**1,788,300**	**2,119,524**	**2,428,285**	**2,796,160**

Source: Company data, Nomura estimates

Exhibit 75. Bank of India — key ratios

Year-end 31 Mar	FY07	FY08	FY09E	FY10E	FY11E
Growth rates (%)					
Deposit Growth		25.1	21	15.5	16
Loans Growth		33.6	23.5	15	18
Operating profit growth		54.5	45	0	13.9
Provisions Coverage Ratio		78.7	65	60	60
Profitability ratios (%)					
Net Interest Margin	2.8	2.9	3.2	2.9	2.9
RoE	21.2	27.6	29.3	17.4	18.1
RoA	0.9	1.3	1.5	0.9	1
Gross NPAs to Adv.	2.4	1.7	1.8	3.6	4.6
Net NPAs to Adv.	0.7	0.4	0.6	1.5	1.9
CAR	11.8	12	12.7	11.5	11.2
Tier 1	6.5	7.7	8.7	8.1	8.1

Source: Company data, Nomura estimates

Union Bank of India — limited upside

Stock rating: NEUTRAL
Sector view: NEUTRAL
Ticker: UNBK IN
Price as of 09 March (INR): 117
Price target (INR): 130
Potential upside/downside: 12%
YTD price perf (Abs): -28%
YTD price perf (Rel): -13%

We believe Union Bank of India has been delivering strong operating performance over the past two years, driven by a significant improvement in deposit mix and focus on brand building. The bank's provisioning cover is among the highest at 93%. While fundamentals are strong, we expect incremental ROEs for the bank to come under severe pressure with declining margins, slowing growth and rising NPLs. We expect tier-I CAR to fall to 7% by 11 March, but the bank does not have much leeway to raise fresh equity, with the government holding a 55% stake, which cannot fall below 51% owing to banking regulations. Our price target of INR130 at 0.7x P/BV is based on a target ROE of 11%, which is substantially lower than the last reported ROE of 27% largely due to high credit costs and lower leverage. The stock is currently trading at 0.8x FY10E P/BV. We see limited potential upside to current valuations as we expect the bank's profitability to deteriorate.

We expect loan growth to slow to 14% in FY10E and 15% in FY11E from 25% y-y in 9M FY10, with a substantial slowdown in SME and retail loans. At 14%, we believe the bank's loan growth will be still higher compared with other large state banks, given the lower base.

We expect earnings growth to decline by 9% in FY10E on the back of higher credit costs and slower recoveries. We expect earnings growth of 11% in FY11E.

We have modelled NPLs to increase 3.3x over current levels by FY11. Union Bank has the highest proportion of unseasoned loans among the Indian banks under our coverage. With 53% of SME loans and 63% of total loans being unseasoned, as of December 2008, we believe this poses high asset quality risks.

Exhibit 76. Union Bank of India — summary of key financials and market data

Key financials (INRmn)	FY08A	FY09E	FY10E
Op profit	25,804	32,032	35,795
Net profit	13,871	19,463	17,618
EPS	27.46	38.53	34.88
DPS	4.00	6.50	7.50
BVPS	111	142	168
Yield	3.4	5.6	6.4
P/BV	1.1	0.8	0.7
P/E	4.3	3.0	3.4

Key ratios	FY08A	FY09E	FY10E
RoE (%)	24.67	27.09	20.72
RoA (%)	1.1	1.3	1.0
Tier I CAR (%)	7.5	7.4	7.4
EPS growth (%)	64.1	40.3	(9.5)

Market data	
Ticker	UNBK IN
Market cap (US$mn)	1,207
Shares outstanding (mn)	505
Free float	45%

Source: Bloomberg

Source: Company data, Nomura estimates, Bloomberg for price chart

Investment summary

Improvement in core operating performance

Union Bank's core operating performance turned around in FY07 after two weak years when profit growth remained flat. We believe the turnaround was driven by the new Chairman Mr M V Naik, who assumed office in April 2006. The Chairman focused on improving margins, increasing the pace of recoveries and investing in technology to improve the share of fees in total income. As a result, NIMs improved from 2.8% in FY05 to 3.22% by December 2008, and CASA improved from 32% to 35% during the same period; operating profit grew by 20% during FY05-FY08, net profit by 25%, fee income by 23%, and the ratio of net NPLs at 0.2% as of December 2008 is the lowest in the domestic banking industry.

Sound technology and focus on branding

The bank has invested heavily in technology and brand building over the past few quarters, and we expect these efforts to show results over the next few years. In fact, fee growth and CASA have already improved.

Loan growth to moderate

After two years of strong growth, we now expect loan growth to moderate to 14% in FY10E and 15% in FY11E, albeit still higher than the sector, given the lower base. We expect NIM to fall to 2.8% by FY11E from 3.2% currently. We expect NPLs to increase 3.2x over FY08-FY11E given the high proportion of unseasoned loans. We also expect credit costs to increase from 0.6% of loans in FY08 to 1.0% of loans in FY10-FY11. Overall, we expect earnings to decline by 9% in FY10E, before rebounding to 13% y-y in FY11E.

Limited leeway to raise fresh capital

The government of India holds a 55% stake in the bank, is close to the floor of 51%, which indicates that the bank has limited leeway to raise fresh capital. We expect the bank's tier-I ratio to fall to 7% by FY11, which implies that the bank will likely need fresh funds to support our forecast asset growth before March11. We believe that the inability to raise capital will be an overhang for the stock.

The stock is currently trading at 0.8x P/BV FY10E. While it trades below book value, we see limited potential upside as we expect earnings to deteriorate and NPLs to increase significantly over FY09-FY11.

Valuation methodology

Our 12-month price target of INR130. Our target P/BV multiple of 0.7x is based on a sustainable ROE of 11%. Our target ROE assumption of 11% is substantially lower than the reported Roe of 27% for FY08 due to two key factors: 1) higher credit costs of 1% against 0.6% in FY08 and 2) leverage of 18x against 22x currently.

Exhibit 77. Union Bank of India — price target derivation

Net int inc/assets	2.6	2.6
Non-int inc/assets	0.8	0.8
Non-oper profits /assets	0.3	0.1
Opex / assets	1.4	1.5
Oper profits/assets	2.3	2.0
Provisions/assets	0.6	1.0
(1-tax rate)	58.0	67.0
RoA	1.2	0.6
Assets/equity (x)	21.9	17.5
RoE	26.8	11.1
Risk free rate		5.5
Risk premium		6.0
Beta		1.4
CoE		13.3
g		4.5
Target P/BV		0.8
BVPS (INR)		164
Target price of standalone bank (INR)		128
Total fair value		128
Rounded off (INR)		130

Source: Company data, Nomura estimates

Valuation and price performance

We believe Union Bank has been among the better performing bank stocks in the domestic market, outperforming the Sensex by 38% over the past six months and by 20% over the past year due to its improving profitability and asset quality. The stock currently trades at 0.8x FY10E P/BV, higher than its historical low of 0.5x. Given the expected earnings slowdown and deterioration in asset quality in FY10-11E, we see limited potential upside to current multiples. We believe the market has still not fully recognised the high proportion of the bank's unseasoned loans, especially SME loans, which are the highest for any bank.

Loan mix and asset quality

SMEs have been the fastest growing lending segment for Union Bank over the past two years. SME loans grew at 37% p.a. during December 2006-08, while total loans grew by 26% during the same period. SMEs account for 16% of the bank's total loans, followed by retail loans including trade (20%), and farm loans (15%).

Exhibit 78. Union Bank of India — loan mix and unseasoned loans

	Dec-06	% to total	Dec-08	% to total	Unseasoned loans	CAGR, Dec-08 over Dec-06,%
Total loans, gross	583,030	100%	929,780	100%	63%	26.3
SME loans	78,100	13%	146,120	16%	53%	36.8
Retail loans	130,160	22%	182,830	20%	71%	18.5
Agri loans	97,560	17%	138,540	15%	70%	19.2
Other loans	277,210	48%	462,290	50%	60%	29.1

Source: Company data, Nomura estimates

Given the high proportion of unseasoned loans, we expect Union Bank's NPLs to rise threefold from the current period up to FY11. We expect gross NPLs to rise from 1.7% in December 2008 to 4.2% by March 2011.

Exhibit 79. Union Bank of India — movement of NPLs

	Gross NPAs	Net NPAs	Slippage, %	Provisioning cover	Provisions to loans	Gross NPLs to Gross Loans	Net NPLs to Net loans
	INR. MM	INR. MM	%	%	%	%	%
FY02	24,205	13,384	4.0	43.8	1.7	10.8	6.3
FY03	23,876	12,534	3.2	46.1	1.8	9.0	4.9
FY04	23,468	8,452	2.7	62.5	2.4	7.6	2.9
FY05	20,582	10,604	1.7	66.8	0.7	5.0	2.6
FY06	20,981	8,340	1.9	59.7	0.5	3.8	1.6
FY07	18,726	6,010	1.4	67.4	0.8	2.9	1.0
FY08	16,566	1,276	1.2	91.2	1.0	2.2	0.2
3QFY09	15,640	1,270	1.1	91.9	0.7	1.7	0.1
FY09E	17,275	1,665	1.4	97.0	0.5	1.8	0.2
FY10E	35,408	10,622	3.5	70.0	1.1	3.2	1.0
FY11E	54,364	19,027	3.0	65.0	1.1	4.2	1.5

Source: Company data, Nomura estimates

Investment risks

- Faster-than-expected loan growth would provide upside to our earnings estimates and price target for Union Bank.
- A sharp decline in bond yields from current levels would benefit Union Bank's earnings.
- Lower delinquencies would also provide upside to our earnings forecasts for the bank.
- Similarly, slower-than-expected loan growth, higher-than-expected delinquencies and an increase in bond yields would likely be key downside risks to our earnings and price target.
- The bank does not have enough leeway to raise fresh capital which is a key risk to growth.

Financials

Exhibit 80. Union Bank of India — profit and loss statement

Year-end 31 Mar INRmn	FY07	FY08	FY09E	FY10E	FY11E
Interest Income	72,272	93,016	119,013	137,061	154,897
Interest Expended	45,920	63,609	79,186	92,538	105,267
Net Interest Income	26,352	29,406	39,827	44,523	49,630
Change (%)	17	12	35	12	11
Other Income	8,415	12,327	11,996	13,307	15,191
Net Income	34,767	41,734	51,823	57,831	64,821
Change (%)	21	20	24	12	12
Operating Expenses	14,759	15,930	19,791	22,036	24,137
Operating profit	20,008	25,804	32,032	35,795	40,684
Change (%)	36	29	24	12	14
Provisions	6,204	7,199	6,258	12,868	15,305
PBT	13,804	18,605	25,774	22,927	25,379
Tax	5,350	4,734	7,217	6,420	7,106
PAT	8,454	13,871	18,557	16,507	18,273
EPS	16.7	27.5	36.7	32.7	36.2
DPS	4	4	7	8	8
BVPS	94	111	140	164	192

Source: Company data, Nomura estimates

Exhibit 81. Union Bank of India — balance sheet

Year-end 31 Mar INRmn	FY07	FY08	FY09E	FY10E	FY11E
Reserves & Surplus	46,848	68,420	83,136	95,211	109,052
Net Worth	51,899	73,471	88,187	100,262	114,103
Deposits	851,802	1,038,586	1,308,619	1,544,170	1,822,121
Borrowings	42,155	47,605	54,746	54,746	54,746
Other Liabilities & Prov.	80,923	81,064	97,277	107,005	117,705
Total Liabilities	1,026,779	1,240,727	1,548,829	1,806,183	2,108,675
Current Assets	84,264	100,973	120,333	163,064	207,128
Investments	279,818	338,226	412,636	486,911	574,555
Loans	623,864	743,483	951,658	1,084,890	1,247,624
Net Fixed Assets	8,250	22,004	22,754	23,654	24,554
Other Assets	30,582	36,041	41,447	47,664	54,814
Total Assets	1,026,779	1,240,727	1,548,829	1,806,183	2,108,675

Source: Company data, Nomura estimates

Exhibit 82. Union Bank of India — key ratios

(%)	FY07	FY08	FY09E	FY10E	FY11E
Deposit Growth	14.96	21.93	26		
Loans Growth	16.87	19.17	28	14	15
Net Interest Margin	2.86	2.92	3.21	2.97	2.85
RoE	19.16	26.79	29.19	21.44	20.32
RoA	0.88	1.22	1.33	0.98	0.93
Gross NPAs to Adv.	2.94	2.18	1.81	3.21	4.25
Net NPAs to Adv.	0.96	0.17	0.06	0.98	1.53
CAR	12.8	12.51	11.96	11.59	11.23
Tier 1	7.79	7.45	7.4	7.35	7

Source: Company data, Nomura estimates

Axis Bank — sharp slowdown already priced in

Stock rating: BUY
Sector view: NEUTRAL
Ticker: AXSB IN
Price as of 09 March (INR): 281
Price target (INR): 400
Potential upside/downside: 42%
YTD price perf (Abs): -44%
YTD price perf (Rel): -29%

We initiate coverage of Axis Bank with a BUY rating and a 12-month price target of INR400. Our price target is based on our target FY10E P/BV multiple of 1.3x. Axis Bank has been the fastest-growing bank in India — its loans and profit posted CAGRs of 56% and 27% over FY05-FY08. We expect flat (2%) earnings growth in FY10E and 13% in FY11E substantially slower than the 9M09 growth rate of 73%, due to a moderation in loan growth to 25% over the next two years, rising credit costs and slower fees. While we expect a slowdown in earnings and a rise in NPL, we believe these negatives are priced in after the recent sharp price correction. Axis Bank trades at below book (0.9x FY10E P/BV), the lowest in the past five years, which we believe is unjustified given its growing brand franchise and strong management team. With focused geographical expansion, Axis Bank's savings deposits per branch, which is a key indicator of brand strength, is higher than that of HDFC Bank and ICICI Bank. Our target multiple of 1.3x assumes a discount of 39% to HDFC Bank's, which is the average discount that it has traded at over the past two years. While we estimate that its net profit growth will drop to 7% over FY09E-11E, growth in core operating profit will remain strong at 23% in FY09E-11E

We believe Axis Bank has built a strong franchise with one of the highest proportions of low-cost savings and current deposits in the sector, a key strength in the current environment, in our view. However, Axis Bank has been amongst the worst performing bank stocks in India. The sharp underperformance has been driven by expectations of deterioration in profitability, uncertainties regarding the new CEO once the current CEO Dr Nayak retires in July 2009 and overhang from the 27% stake of Specified Undertaking of Unit Trust of India (SUUTI) in the bank that can be offered for sale any time. We believe these concerns have been priced in with the recent sharp correction in price.

Exhibit 83. Axis Bank — summary of key financials and market data

Key financials (INRmn)	FY08A	FY09E	FY10E
Op profit	22,259	33,952	41,112
Net profit	10,711	16,404	16,748
EPS	29.76	45.86	46.82
DPS	6.00	8.00	8.00
BVPS	245	282	320
Yield	2.0	2.7	2.7
P/BV	1.2	1.0	0.9
P/E	9.9	6.4	6.3

Key ratios	FY08A	FY09E	FY10E
RoE (%)	17.5	17.4	15.6
RoA (%)	1.2	1.3	1.0
Tier I CAR (%)	10.2	9.1	8.6
EPS growth (%)	49.6	54.1	2.1

Market data	
Ticker	AXSBIN
Market cap (US$mn)	2,161
Shares outstanding (mn)	359
Free float	58%

Source: Company data, Nomura estimates, Bloomberg for price chart

Investment summary

- Consistently improving franchise. We believe that over the past five years, Axis Bank has evolved as a strong bank with a sound management team, fast expanding branch network, among the best deposit mix in the sector and the highest proportion of core fees in the sector. While the proportion of low-cost deposits has declined y-y for Axis Bank, at 38%, it is still higher than SBI's 34% and PNB's 37%. We attribute the high proportion of low-cost deposits to the rapid growth in savings deposits, given the bank's focus on rapid geographic expansion. Similarly, the proportion of Axis Bank's fee income to total assets is among the highest in the sector and compares well to HDFC Bank and ICICI Bank. Its deposit franchise is also getting more valuable with consistent improvement in savings deposits per branch.

  The table below shows the bank's consistent improvement in deposit per branch and comparison with the other two large private banks.

Exhibit 84. Savings deposits per branch

	(INRbn)	Savings	No of branches	Savings deposits per branch (INRbn)
HDFC Bank	Dec-08	330,810	1,412	234
	Mar-08	261,539	761	344
	Mar-07	195,848	684	286
ICICI Bank	Dec-08	386,000	1,416	273
	Mar-08	390,890	1,308	299
	Mar-07	288,390	755	382
Axis Bank	Dec-08	218,880	749	292
	Mar-08	162,780	671	243
	Mar-07	121,259	561	216

Source: Company data

Note that HDFC Bank's CASA ratio has deteriorated after its merger with Centurion Bank. We expect Centurion Bank branches to scale up close to HDFC Bank's productivity levels over the next two years. For ICICI Bank, the deterioration in the quarter ending December 2008 was due to unsubstantiated speculation about the bank's liquidity position.

- A slowdown after three years of strong growth. Axis Bank has been the fastest-growing bank, posting CAGRs of 56% in loans, 47% in net profit and 27% in EPS over FY05-08E. Rapid geographic expansion, which led to improved deposit mix, focus on broad basing fee income and low provisioning costs were the key contributors to this rapid growth. We believe the bank's fundamentals will deteriorate, as we expect slower loan and earnings growth and deterioration in the bank's asset quality. Already, some pressures on core profits were visible in 3QFY09. Excluding the write-back of investment depreciation provisions, we believe that pre-tax profits would have been flat q-q in 3QFY09. The reason for the flat growth in core profits in 3QFY09 was slower fees and pressure on margins, as the bank had to rely on high-cost term deposits to fund the loan commitments that were already tied up in the previous quarters.

- **Earnings growth to drop to 7% over FY09-11E, but we believe growth in core profit will remain strong at 23% over the same period.** We expect loan growth to slow to 25% over FY09-11 and earnings growth to drop to 7% over the same period, driven by higher provisions, slower loans and fees. While we believe earnings growth will slow to 7% over FY09-11E, we estimate that growth in core operating profit will be healthy at 23% over the same period, albeit slower than the 51% growth rate seen in FY05-FY08E.

- **Sharp build up in NPLs.** We expect the bank's NPL to rise 7x between FY08 and FY11E, owing to its aggressive loan growth in the past two years and high SME exposure of 19%-plus. We expect gross NPL to rise to 2.7% in FY11, from 0.8% of loans in FY08.

- **Stable margins.** Axis Bank has a high proportion of bulk deposits at 47% of total. The bank's reliance on bulk deposits increased in 3Q FY09, owing to the October liquidity crunch. Since 3Q FY09, bulk deposit rates for the sector have been down 600bp from the peak and 400 bp on average. We believe Axis Bank is likely to be a key beneficiary of falling bulk deposit rates, especially in 2H FY10E when the high cost bulk deposits contracted in 3Q FY09 will likely mature. We believe the correction in term deposit cost will be offset by pressure on loan yields. As such, we expect margins to remain stable for UTI Bank (what is UTI Bank?) at 2.9% over our forecast period against our assumptions of declining margins for the rest of the sector, (except for ICICI Bank).

- **Strong management team.** CEO Dr Nayak deserves credit for bank's rapid and high quality growth, in our view. He has headed the bank since 2000. While investors have recognised the efforts of Dr Nayak, one key investor concern over the past few years was that Axis Bank's management team was not broad-based. Over the past two years, Axis Bank has created a robust top and middle management team addressing investor concerns about its management structure. Dr Nayak is due to retire in July 2009.

- **Adequate capitalisation**. The bank's current tier-I CAR of 9.5% is adequate to support growth for the next two years, in our view. We expect its tier-I CAR to fall to 7.9% by FY11E.

Valuation methodology

Our price target is based on a fair RoE of 15.3% and CoE of 13.3%. Our fair RoE of 15.3% is lower than the bank's reported RoE of 17.7% for FY08, as we have assumed credit costs to rise to 1.1% of assets against 0.6% in FY08. Our target FY10E P/BV works out to 1.3x

Exhibit 85. Axis Bank — price target derivation

(%)	FY08	Target
Net int inc/assets	2.8	2.7
Non-int inc/assets	1.7	1.7
Non-oper profits /assets	0.2	0.1
Opex / assets	2.4	2.1
Oper profits/assets	2.4	2.4
Provisions/assets	0.6	1.1
(1-tax rate)	64.9	67
RoA	1.2	0.9
Assets/equity (x)	15.0	17
RoE	17.5	15.3
Risk free rate		5.5
Risk premium		6
Beta		1.3
CoE		13.3
g		5.5
Target P/BV		1.3
BVPS(INR).		320
Target price of standalone bank (INR)		402
Fair value of subsidiaries		-
Total fair value		400
Rounded off to (INR)		400

Source: Company data, Nomura estimates

Valuation and price performance

Axis Bank trades at 0.9x FY10E P/BV, which is close to its trough valuation in the past five years. The stock has underperformed the market by a wide margin of 15% over the past year, due to the following concerns:

- Concerns regarding a substantial slowdown in y-y- earnings growth.
- Uncertainties regarding the new CEO after the retirement of Dr Nayak. Under Dr Nayak, Axis Bank has emerged as the fastest-growing bank in India and is now among the top three private banks in the country. He is due to retire in July 2009. Overhang from SUUTI's stake. Axis Bank was promoted by erstwhile UTI, now wound up and its assets, including its stake in Axis Bank, transferred to a special purpose vehicle called SUUTI, which has the mandate to gradually dispose of all the assets. SUUTI owns a 27% stake in Axis Bank, which remains an overhang on the stock.

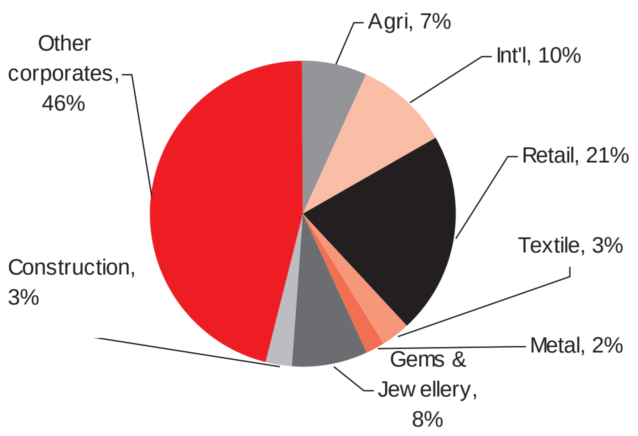
We believe a lot of these negatives are already priced in at the current low valuations of 0.9x FY10E P/BV.

Loan mix and asset quality

Loan mix is dominated by corporate loans

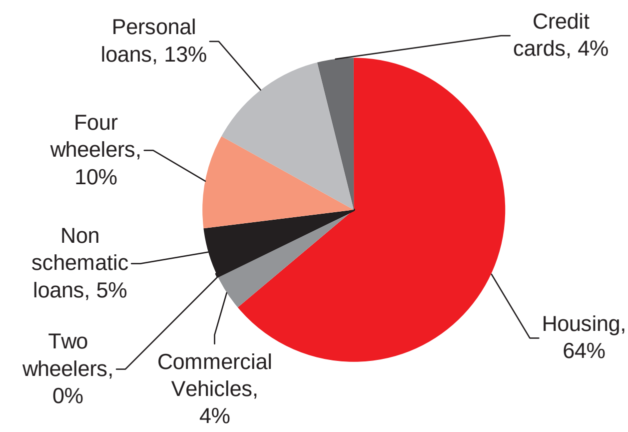
Large and mid-sized corporate loans form 43% of total loans and SMEs form another 20%. Retail loans account for 21% of total loans. Axis Bank also has overseas branches in Dubai, Hong Kong and Singapore and a representative office in China. International loans account for 10% of total loans. SME loans have registered the highest growth among all lending segments in India over the past two years. While total loans have grown at a strong 52% p.a. over FY06-FY08, SME loans have grown at a faster pace of 57% y-y.

Exhibit 86. Axis Bank — total loans



Source: Company data

Exhibit 87. Axis Bank — retail loans



Source: Company data

NPLs to rise sharply off a low base

Axis Bank's NPLs are currently low with gross NPL at 0.9% of loans and net NPL at 0.4% of loans. The provisioning cover, including write-offs, is strong at 84%. We expect its NPL to rise 8x over the March 2008 levels and 5x over the December 2008 levels, as asset quality catches up with historical loan growth. It has a high proportion of unseasoned loans. A high 40% of SME loans and 60% of retail loans have been lent over in the past two years. These segments could see higher delinquencies than the large and mid-corporate segment in the economic downturn. We expect gross NPLs to rise, from INR7.8bn in December 2008, to INR41bn in FY11 (i.e. from 0.9% of loans to 2.7% of loans).

Exhibit 88. Axis Bank — unseasoned loans and contribution of different loan segments to total growth

	Dec-06 (INRmn)	Dec-07 (INRmn)	Dec-08 (INRmn)	Incremental loans (INRmn) Dec-08 over Dec-06	% contribution to incremental growth	Unseasoned loans (%) Dec-08 over Dec-06	CAGR (%)
SME	57,210	90,080	141,450	84,240	20	40	57
Retail	91,780	120,090	156,160	64,380	15	59	30
Agriculture	23,370	36,790	55,990	32,620	8	42	55
International	46,510	61,858	75,328	28,818	7	62	27
Large and mid corporates	105,344	177,412	324,352	219,008	51	32	76
Total loans	324,213	486,230	753,280	429,067	57	43	53

Source: Company data

Exhibit 89. NPLs for Axis Bank

	Gross NPls	Net NPls	Gross NPLs (%)	Net NPLs (%)	Slippages (%)	Loan provisions / loans (%)
FY02	2,822	1,854	4.0	3.5	4.1	4
FY03	2,289	1,620	2.5	2.3	1.9	1
FY04	2,747	1,122	2.3	0.9	3.4	3
FY05	3,111	2,169	1.5	1.1	1.4	0
FY06	3,779	2,198	1.3	0.8	1.2	1
FY07	4,187	2,663	0.9	0.6	0.8	0
FY08	4,946	2,483	0.7	0.4	1.0	1
3QFY09	7,880	3,420	0.9	0.4	na	1
FY09	10,009	2,899	1.0	0.3	1.0	1
FY10	23,865	11,523	1.9	0.9	2.0	1.3
FY11	41,561	23,347	2.7	1.6	2.0	1.4

Source: Company data

Key earnings drivers

- We expect loan growth to slow 25% in FY10-11E from 56% over FY05-08E.
- We expect NIM (calculated on balance sheet averages) to remain stable at 2.9%, as falling deposit cost will be offset by lower loan yields. For most other banks, we expect their margins to decline.
- We expect net interest income to increase 26% y-y in FY10 and 25% y-y in FY11E.
- We have modelled loan provisions at 1.1% of loans in FY10E and 1.3% of loans in FY11E against 0.6% of loans in FY08E.
- We expect core fees to rise 25% over the next two years.
- Overall core operating profit will likely grow at a healthy 23% in FY10 and FY11E. However, higher provisions will cause net profit growth to be much lower at a modest 2% y-y in FY09E and 13% y-y in FY11E.
- We expect RoE to fall from 17.5% in FY08 to 15.5% in FY11. We also expect its RoA to fall from 1.2% to 0.96% over the same period.
- We expect its tier-I CAR to decline from 9.5% currently to 7.9% by FY11. We believe Axis Bank has adequate capital to support our forecast growth over the next two years.

Investment risks

- Faster-than-expected loan growth would provide upside to our earnings estimates and price target for Axis Bank.

- A sharp decline in bond yields from current levels would benefit earnings.

- Lower delinquencies will also provide upside to our earnings forecasts for the bank.

- Similarly, slower-than-expected loan growth, higher-than-expected delinquencies and an increase in bond yields would likely be key downside risks to our earnings and price target.

- Uncertainty about the new CEO and overhang from SUUTI stake remain key investment risks for the stock.

Financials

Exhibit 90. Axis Bank — profit and loss

Year-end 31 Mar (INRmn)	FY07	FY08	FY09E	FY10E	FY11E
Interest earned	44,617	70,053	111,959	135,895	167,131
Interest expended	29,932	44,200	76,658	91,262	111,219
Net interest income	14,684	25,854	35,301	44,633	55,912
Non-interest income	10,101	17,955	27,948	33,509	41,201
of which trading gains	609	2,203	2,000	1,500	1,500
Employee expenses	3,813	6,702	10,128	14,041	18,838
Other operating expenses	8,332	14,847	19,169	22,990	28,003
Operating expenses	12,146	21,549	29,297	37,031	46,842
Pre-provision profit (Operating profit)	12,640	22,259	33,952	41,112	50,272
Pre-provision profit excluding trading gains	12,031	20,057	31,952	39,612	48,772
Loan loss provisions	737	3,440	6,396	13,343	18,715
Tax	3,372	5,753	9,227	9,421	10,641
Others	1,269	2,356	1,924	1,600	2,000
Provisions & contingencies	7,036	11,614	17,548	24,363	31,355
Net profit	**5,604**	**10,711**	**16,404**	**16,748**	**18,917**
EPS	19.90	29.76	45.86	46.82	52.88
DPS	4.50	6.00	8.00	8.00	8.00

Source: Company data, Nomura estimates

Exhibit 91. Axis Bank — balance sheet

Year-end 31 Mar (INRmn)	FY07	FY08	FY09E	FY10E	FY11E
Assets					
Cash	8,368	15,203	14,732	18,120	22,288
RBI+bank balances and money at call	60,816	51,986	122,764	151,000	185,730
Government + other approved securities	164,308	201,788	266,830	302,501	339,382
Non-SLR investments	104,663	135,263	161,080	195,968	239,547
Total investments	**268,972**	**337,051**	**427,910**	**498,469**	**578,928**
Advances	368,765	596,611	853,154	1,066,443	1,333,054
Fixed assets	6,732	9,229	12,427	13,447	14,467
Other assets	18,921	27,845	29,098	30,408	31,776
Total assets	732,572	1,037,925	1,460,086	1,777,887	2,166,243
Liabilities	**FY07E**	**FY08E**	**FY09E**	**FY10E**	**FY11E**
Equity capital	2,816	3,577	3,577	3,577	3,577
Reserves (Excluding revaluation reserves)	31,206	84,130	97,230	110,919	126,596
Shareholders' funds	34,022	87,707	100,807	114,496	130,173
Deposits	587,856	876,262	1,227,643	1,510,001	1,857,302
Borrowings (including subordinated debt)	73,235	56,240	64,676	74,378	85,535
Other liabilities	37,459	56,745	66,959	79,012	93,234
Total liabilities	732,572	1,076,954	1,460,086	1,777,887	2,166,243

Source: Company data, Nomura estimates

Exhibit 92. Axis Bank — key ratios

	FY07	FY08	FY09E	FY10E	FY11E
Growth rates (%)					
Assets	47.3	41.7	40.7	21.8	21.8
Loans	65.3	61.8	43.0	25.0	25.0
Deposits	46.5	49.1	40.1	23.0	23.0
Revenues	37.1	76.8	44.4	23.5	24.3
Operating expenses	49.2	77.4	36.0	26.4	26.5
Operating profit	27.2	76.1	52.5	21.1	22.3
Net profit	15.5	90.0	54.1	2.1	12.9
EPS	14.3	49.6	54.1	2.1	12.9
Profitability measures (%)					
Net interest margin	2.61	3.10	2.92	2.83	2.90
RoA	0.91	1.18	1.29	1.03	0.96
RoE	17.82	17.49	17.40	15.56	15.46
RoRWA	1.18	1.49	1.51	1.15	1.09
Core RoE	16.6	15.1	16.0	14.7	14.7
Cash adj RoE					
Return on RWAs (RoRWAs)					
Cash adj RoRWAs					
Cost (ex g'will)/assets	1.98	2.36	2.29	2.29	2.38
Asset quality measures					
Gross NPLs (INRmn)	4,187	4,946	10,009	23,865	41,561
Net NPLs (INRmn)	2,663	2,483	2,899	11,523	23,347
Gross NPLs, %	0.9	0.7	1.0	1.9	2.7
Net NPLs, %	0.59	0.35	0.29	0.95	1.56
Provisions/ Gross NPLs, %	36	50	71	52	44
Leverage & capital measures (%)					
Loan/deposit ratio	62.7	68.1	69.5	70.6	71.8
Equity/assets	4.6	8.5	6.9	6.4	6.0
Tier 1 CAR	6.4%	10.2%	9.1%	8.6%	7.9%
Tier II CAR	5.2%	3.6%	3.5%	2.9%	3.0%

Source: Company data, Nomura estimates

PNB — more defensive than other state banks

Stock rating: BUY
Sector view: NEUTRAL
Ticker: PNB IN
Price as of 09 March (INR): 304
Price target (INR): 420
Potential upside/downside: 38%
YTD price perf (Abs): -42%
YTD price perf (Rel): -27%

We initiate coverage of Punjab National Bank (PNB) with a BUY rating and a 12-month price target of INR420. Our price target is based on a target ROE of 12.3% and COE of 13.3%. We expect earnings to decline 9% in FY10E and then rebound 16% in FY11E owing to higher credit costs, declining margins and lower trading gains. We believe PNB has the following three key strengths, which should help it in the current challenging economic environment: 1) it has the highest proportion of low-cost savings deposits at 31%, 2) provisioning cover is healthy at 83% – amongst the strongest in the domestic banking sector, and 3) a relatively small 10% of its total investments are under the mark-to-market category.

PNB is currently trading at 0.7x one-year forward P/BV which is close to its historical trough of 0.75x. We see potential upside to PNB's current price, driven by its healthy provisioning cover of 83% which provides cushion to absorb future shocks, technical NPLs of INR5bn (of total NPLs of INR33bn that will likely be upgraded over the next few quarters) and higher-than-sector CASA of 40%. PNB has underperformed the SENSEX sharply by 27% year to date despite strong results.

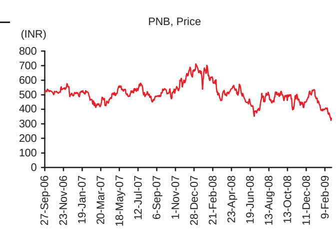
We expect loan growth of 10% in FY10E, as SME and retail loans slow.

We expect PNB's NPLs to rise 2.7x as the bank has a large proportion of small sized loans. We expect provisioning cover to fall to 73% by FY11E, but still remain stronger than the sector average of 65%.

We believe PNB is more defensive than other PSU banks, with a relatively lower proportion of bonds in the AFS category at 10% of the total, high provisioning cover, improving fees and higher-than-sector margins.

Exhibit 93. PNB — summary of key financials and market data

Key financials (INRmn)	FY08A	FY09E	FY10E	Key ratios	FY08A	FY09E	FY10E	Market data	
Op profit	40,062	51,690	54,113	RoE (%)	19.3	20.1	15.7	Ticker	PNB IN
Net profit	20,488	24,421	22,152	RoA (%)	1.1	1.1	0.9	Market cap (US$mn)	1,956
EPS	64.98	77.46	70.26	Tier I CAR (%)	9.0	8.8	8.2	Shares outstanding (mn)	315
DPS	13.00	13.00	13.00	EPS growth (%)	33.0	19.2	(9.3)	Free float	40%
BVPS	351	420	474						
Yield	4.3	4.3	4.3						
P/BV	0.9	0.7	0.6						
P/E	4.7	3.9	4.3						



Source: Bloomberg

Source: Company data, Nomura estimates, Bloomberg for price chart

Investment summary

Loan growth to slow

After witnessing rapid loan growth of 25% during FY05-08E, we expect loan growth for PNB to slow to 10% in FY10 and recover to 15% by FY11. We expect the slower loan growth, decline in margins, lower treasury gains and higher credit costs will result in earnings growth declining 9% in FY10E, after significant earnings growth of 86% y-y in 3QFY09E.

NIMs and CASA to decline – but still higher than the sector

We expect PNB's key strengths – higher-than-sector CASA and higher-than-sector margins to deteriorate. However, we believe they will still remain better than the domestic banking sector average. Although PNB's CASA deteriorated to 37% in 3QFY09 from 39% in FY08, it is still higher compared with most other large domestic banks. PNB's NIM expanded by 19bp y-y to 3.85% in 9M FY09, as against 3.58% in 9M FY08. The expansion in margins was driven by a higher incremental credit-deposit ratio of 108%, better pricing power for loans and CRR cuts. We believe NIM expansion is unsustainable, as we expect pressure on lending rates from here on. Therefore, we expect NIMs to fall to 3.3% in FY10E and stabilise at 3.2% in FY11E. However, we believe PNB's NIM and CASA will continue to be higher than the sector average.

Bad loans to increase

We expect bad loans to catch up with the historical high loan growth in FY10E like the rest of the sector. We expect PNB's NPLs to rise 2.7x between now and FY11E. Consequently, we expect its credit costs to increase to 1.1% of loans in both FY10 and FY11 from 0.9% in FY08. PNB's credit costs in FY08 are higher compared with other large state banks. Comparable credit costs were 0.5% for SBI, although slippages were similar at close to 2%. We believe PNB has been prudent in making higher provisions for its bad loans.

High provisioning cover provides comfort

We believe PNB's provisioning cover, at 83% of total loans, is the highest among the domestic banks under our coverage, as the bank has made aggressive provisioning over the past two years. This, we believe, provides a good cushion to absorb future shocks. In addition, the chairman has clarified that PNB has technical NPLs of INR5bn accounting for 15% of the total stock of NPLs which will likely be upgraded over the next few quarters.

Strong management

The chairman Dr Chakraborthy is well regarded in domestic banking circles. On joining the bank in 2007, Dr Chakraborthy focused on cleaning up the loan book and repaying bulk deposits to revive spreads. The results were evident in FY08 and 9MFY09 earnings, NIMs improving y-y and high provisioning cover. PNB has now built a strong technology platform.

Adequate capital

We believe PNB's tier-I CAR of 9.4%, as of December 2008, is adequate to support growth over the next two years. We do not see the need for a fresh equity issue. The government holds a 58% stake in PNB, and this stake cannot fall below 51% owing to banking regulations. Therefore, we believe PNB has leeway for a fresh issue of only around US$150mn.

PNB is currently trading at 0.7x FY10E P/BV, close to its historical low P/BV. We believe it could trade higher at 0.9-1x given its higher-than-sector ROE and high provisioning cover.

Relatively small proportion of AFS bonds

PNB holds 10% of its investments under the AFS category, which is lower compared with other banks. Given the smaller proportion of AFS bonds, we believe PNB will be less affected by rising/volatile bond yields compared with other state banks.

Exhibit 94. AFS bonds to total bonds

	% AFS
Bank of India	21
PNB	10
SBI	34
Union Bank	37

Source: Company data

Valuation methodology

We have valued PNB at an ROE of 12% and COE of 13.3% as shown below. Our target ROE of 12% is lower than the reported ROE of 18.8% due to the higher provisioning and lower trading gains.

Exhibit 95. PNB — price target derivation

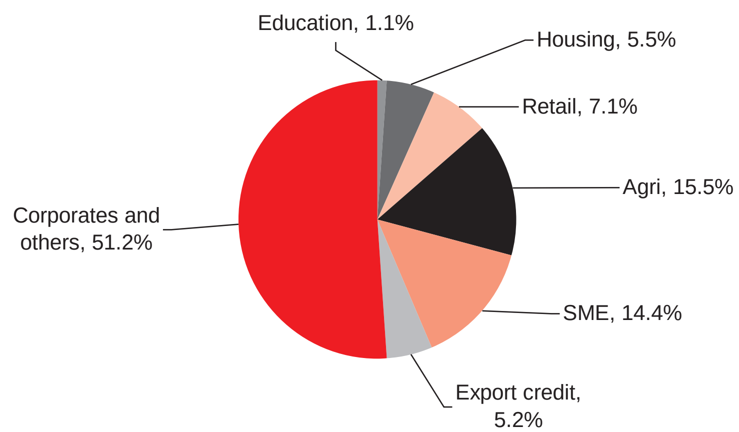
	FY08	Target
Net int inc/assets	3.1	3.1
Non-int inc/assets	0.9	0.9
Non-oper profits /assets	0.2	0.1
Opex / assets	2.0	2.0
Oper profits/assets	2.2	2.1
Provisions/assets	0.5	1.0
(1-tax rate)	66.4	67.0
Minorities/assets	-	
RoA	1.14	0.7
Assets/equity (x)	17.0	17.5
RoE	19.3	12.3
Risk free rate		5.5
Risk premium		6.0
Beta		1.3
CoE		13.3
g		4.5
Target P/BV		0.9
BVPS, INR.		474
Target price of standalone bank, INR		421
Likely Impairment for foreign banking subsidiaries		
Fair value of subsidiaries		-
Total fair value		421
Rounded off to (INR)		420

Source: Company data, Nomura estimates

Loan breakdown and asset quality

Corporate loans account for 50% of PNB's total loans, followed by agricultural loans (15%), and SME loans (14%). PNB's loans to SMEs, traders and mid-sized firms have grown at 45% y-y over the past 12 months.

Figure 96: PNB's loan mix



Source: Company data

Asset quality

PNB's asset quality improved substantially in 9MFY09, with gross NPLs, as at end December 2008, down 23% y-y and net NPLs down 58% y-y. We expect NPls to catch up with PNB's strong historic loan growth of 23% during FY05-08, and an even stronger loan growth of 39% in 9MFY09. PNB has a high proportion of unseasoned loans. Around 38% of its loans were lent over the past two years. PNB has reported that SME loans account for 14% of its total balance sheet, which is comparable to other large state banks. However, given PNB's wide presence in rural and semi-urban areas, we believe that its large portion of corporate loans which account for 51% of its total loans, are too small and are exposed to mid-sized borrowers where the risk of default is higher in an economic downturn.

NPLs to increase

We expect PNB's NPLs to grow 2.7x over FY08-11E from 2.3% of loans as of end-December 2008 to 4.3% by March FY11. We believe PNB's high provisioning cover of 83% will help offset some of this deterioration. We expect new NPLs to increase from 1.6% of loans in 3QFY09 to 3.0% in FY10-11E. We expect credit costs to be at 1.1% of loans against 0.6% during 9M FY09.

Exhibit 97. PNB — movement of NPLs

	Gross NPAs	Net NPAs	Slippage	Prov/Gross NPLs	Loan loss prov / loans	Gross NPLs	Net NPLs
	INRmn	INRmn	%, one year lag	%	%	%	%
FY02	41,399	18,100	4.2%	56%	1.8%	11.4%	5.3%
FY03	49,801	15,269	3.0%	69%	2.1%	11.8%	3.8%
FY04	46,701	4,490	2.6%	98%	2.5%	9.4%	1.0%
FY05	37,413	1,194	1.5%	97%	0.3%	5.9%	0.2%
FY06	31,383	2,102	1.5%	93%	0.4%	4.0%	0.3%
FY07	33,907	7,256	2.8%	79%	0.6%	3.3%	0.8%
FY08	33,189	11,068	2.0%	67%	0.9%	2.6%	0.9%
3QFY09	32,640	5,520	1.7%	83%	0.6%	2.3%	0.4%
FY09E	37,090	6,227	2.0%	83%	0.8%	2.3%	0.4%
FY10E	69,054	22,749	3.0%	67%	1.1%	3.8%	1.3%
FY11E	88,494	23,906	3.0%	73%	1.1%	4.3%	1.2%
CAGR FY08-FY11E	38.70%	29.20%					

Source: Company data, Nomura estimates

Key earnings drivers

We expect earnings to fall 9% in FY10E and then grow 16% in FY11E. The slowdown will be driven by lower NIMs, lower loan growth and higher provisions.

We expect loans to grow 10% in FY10E and 16% in FY11E.

NIMs will likely fall from 3.5% in FY09E to 3.25% in FY10E as loans reprice faster than deposits.

We expect trading gains to fall from 36% of operating profit in 3QFY09 to 55 in FY10/11E.

Credit costs will likely rise to 1.1% of loans in FY10/11E from 0.6% in 9MFY09E.

We forecast Tier I CAR of 8.2% by Mar-11E against 9.4% as at end Dec-08. We do not see the bank raising fresh capital over our forecast period.

Investment risks

- Faster-than-expected loan growth would provide upside to our earnings estimates and price target for Punjab National Bank.
- A sharp decline in bond yields from current levels would benefit the bank's earnings.
- Lower delinquencies would also provide upside to our earnings forecasts for the bank.
- Similarly, slower-than-expected loan growth, higher-than-expected delinquencies and an increase in bond yields will likely be key downside risks to our earnings and price target.

Financials

Exhibit 98. PNB — profit and loss statement

Year-end 31 Mar (INRmn)	FY07	FY08	FY09E	FY10E	FY11E
Interest earned	112,361	142,650	191,756	210,116	238,849
Interest expended	60,229	87,309	122,252	133,927	151,490
Net interest income	52,132	55,342	69,504	76,189	87,359
Fees and comm	9,700	11,062	13,802	15,459	17,778
Profit on sale of inv	-3,152	4,431	6,000	3,500	3,500
Profit on foreign exchange transactions	1,767	2,114	2,325	2,558	2,814
Others	8,989	2,369	2,100	1,000	2,000
Noninterest income	17,304	19,976	24,228	22,517	26,091
Employee	23,524	24,615	27,735	29,028	30,382
Other operating expenses	9,738	10,639	14,306	15,564	19,960
Operating expenses	33,262	35,255	42,042	44,593	50,342
Pre-provision profit (Operating profit)	36,174	40,062	51,690	54,113	63,108
Pre-provision profit excluding trading gains	39,326	35,632	45,690	50,613	59,608
Loan loss provisions	7,518	7,103	13,408	19,647	22,946
Provisions & contingencies	20,773	19,575	27,269	31,961	37,322
Net profit	15,401	20,488	24,421	22,152	25,786
EPS	48.8	65.0	77.46	70.26	81.78

Source: Company data, Nomura estimates

Exhibit 99. PNB — balance sheet

Year-end 31 Mar (INRmn)	FY07	FY08E	FY09E	FY10E	FY11E
Assets					
Cash	9,634	14,421	14,565	16,604	18,929
RBI+bank balances and money at call	146,821	170,886	213,157	243,355	277,850
Government + other approved securities	352,481	421,135	446,283	559,878	626,878
Non-SLR investments	99,418	118,782	125,875	157,914	176,812
Total investments	451,898	539,917	572,157	717,792	803,689
Advances	965,965	1,195,016	1,565,471	1,722,018	1,980,320
Fixed assets	7,160	10,517	11,674	12,958	14,384
Other assets	39,808	43,808	47,313	51,098	55,185
Total assets	1,621,287	1,974,565	2,424,337	2,763,824	3,150,358
Risk weighted assets	1,015,362	1,318,061	1,687,119	1,889,573	2,116,322
Gross NPLs	33,907	33,189	37,090	69,054	88,494
Net NPLs	7,256	11,068	6,227	22,749	23,906
Liabilities					
Equity capital	3,153	3,153	3,153	3,153	3,153
Reserves (Excluding revaluation reserves)	98,263	107,392	129,046	146,070	164,424
Shareholders' funds	101,416	110,545	132,199	149,223	167,577
Deposits	1,398,597	1,664,572	2,080,715	2,372,015	2,704,098
Borrowings (including subordinated debt)	56,437	116,114	115,592	136,213	160,610
Other liabilities	64,837	86,334	95,831	106,372	118,073
Total liabilities	1,621,286	1,977,566	2,424,337	2,763,824	3,150,358

Source: Company data, Nomura estimates

Exhibit 100. PNB — key ratios

Year-end 31 Mar	FY07	FY08E	FY09E	FY10E	FY11E
Profitability Measures (%)					
Net interest margin	4.0	3.4	3.5	3.2	3.3
RoA	1.0	1.1	1.1	0.9	0.9
RoE	16.0	19.3	20.1	15.7	16.3
Return on RWAs (RoRWAs)	1.6	1.8	1.6	1.2	1.3
Cost (ex g'will)/assets	2.3	2	1.9	1.7	1.7
Asset Quality Measures (%)					
Gross NPLs	3.3	2.6	2.3	3.8	4.3
Net NPLs	0.8	0.9	0.4	1.3	1.2
Provisions/ Gross NPLs	67.2	66.7	83.2	67.1	73
Leverage & Capital Measures (%)					
Loan/deposit ratio	69.1	71.8	75.2	72.6	73.2
Equity/assets	6.3	5.6	5.5	5.4	5.3
Tier 1 CAR	8.9	9	8.8	8.2	8.2
Tier II CAR	3.36	4.21	3.68	3.68	3.06

Source: Company data, Nomura estimates

Important Disclosures:

Companies mentioned

Company	Ticker	Price	Pricing date	Stock/ Sector rating
Axis Bank	AXSB IN	INR281	09 Mar 2009	BUY/NEUTRAL
Bank of India	BOI IN	INR 181	09 Mar 2009	NEUTRAL/NEUTRAL
HDFC	HDFC IN	INR 1,256	09 Mar 2009	REDUCE /NEUTRAL
HDFC Bank	HDFCB IN	INR 799	09 Mar 2009	NEUTRAL/NEUTRAL
ICICI Bank	ICICIBC IN	INR 263	09 Mar 2009	NEUTRAL/NEUTRAL
Punjab National Bank	PNB IN	INR 304	09 Mar 2009	BUY/NEUTRAL
State Bank of India	SBIN IN	INR 895	09 Mar 2009	REDUCE/NEUTRAL
Union Bank	UNBK IN	INR 117	09 Mar 2009	NEUTRAL/NEUTRAL

All share prices mentioned are closing prices unless otherwise stated.

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- A rating of "1", or **"Buy"**, indicates that the analyst expects the stock to outperform the Benchmark over the next 12 months.
- A rating of "2", or **"Neutral"**, indicates that the analyst expects the stock to perform in line with the Benchmark over the next 12 months.
- A rating of "3", or **"Reduce"**, indicates that the analyst expects the stock to underperform the Benchmark over the next 12 months.
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- A rating of "2", or "**Buy**" recommendation indicates that upside is between 10% and 20%.
- A rating of "3", or "**Neutral**" recommendation indicates that upside or downside is less than 10%.
- A rating of "4", or "**Reduce**" recommendation indicates that downside is between 10% and 20%.
- A rating of "5", or "**Sell**" recommendation indicates that downside is more than 20%.

Sectors:

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A "**Bearish**" rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a negative absolute recommendation.

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